



# Individual Income Tax: Deduction Part 3 (Pass-Through Income)

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**Course #3118B**

**Taxes**

**2 Credit Hours**

**Support@PacificCPE.com | (800) 787-5313**

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# INDIVIDUAL INCOME TAX: DEDUCTION PART 3 (PASS-THROUGH INCOME)

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This course covers some of the deductions used to figure taxable income. Topics include: types of other itemized deductions allowable to reduce adjusted gross income and the rules in the TCJA related to claiming a deduction for “qualified business income.”

## LEARNING ASSIGNMENTS AND OBJECTIVES

*As a result of studying each assignment, you should be able to meet the objectives listed below each individual assignment.*

### SUBJECTS

#### Other Itemized Deductions Section 199A Pass-through Income Deductions

Study the course materials from pages 1 to 54

Complete the review questions at the end of each chapter

Answer the exam questions 1 to 10

#### Objectives:

- Identify types of other itemized deductions allowable to reduce adjusted gross income.
- Identify the rules in the TCJA related to claiming a deduction for “qualified business income.”

### NOTICE

This course is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional advice and assumes no liability whatsoever in connection with its use. Since laws are constantly changing, and are subject to differing interpretations, we urge you to do additional research and consult appropriate experts before relying on the information contained in this course to render professional advice.

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## EXAM OUTLINE

- **TEST FORMAT:** The final exam for this course consists of 10 multiple-choice questions and is based specifically on the information covered in the course materials.
- **ACCESS FINAL EXAM:** Log in to your account and click Take Exam. A copy of the final exam is provided at the end of these course materials for your convenience, however you must submit your answers online to receive credit for the course.
- **LICENSE RENEWAL INFORMATION:** This course qualifies for **2** CPE hours.
- **PROCESSING:** You will receive the score for your final exam immediately after it is submitted. A score of 70% or better is required to pass.
- **CERTIFICATE OF COMPLETION:** Will be available in your account to view online or print. If you do not pass an exam, it can be retaken free of charge.

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# CHAPTER 1: OTHER ITEMIZED DEDUCTIONS

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## Chapter Objective

**After completing this chapter, you should be able to:**

- Identify types of other itemized deductions allowable to reduce adjusted gross income.

## I. WHAT'S NEW/REMINDERS

**No miscellaneous itemized deductions allowed.** You can no longer claim any miscellaneous itemized deductions. See *Miscellaneous Itemized Deductions*, later.

**Standard mileage rate.** The 2020 rate for business use of a vehicle is 57.5 cents a mile.

## II. INTRODUCTION

This chapter explains that you can no longer claim any miscellaneous itemized deductions, unless you fall into one of the qualified categories of employment claiming a deduction relating to unreimbursed employee expenses. Miscellaneous itemized deductions are those deductions that would have been subject to the 2% of adjusted gross income limitation. You can still claim certain expenses as itemized deductions on Schedule A (Form 1040, 1040-SR, or Form 1040-NR) or as an adjustment to income on Form 1040 or 1040-SR. This publication covers the following topics.

- Miscellaneous itemized deductions.
- Expenses you cannot deduct.
- Expenses you can deduct.
- How to report your deductions.

### Tip



You must keep records to verify your deductions. You should keep receipts, canceled checks, substitute checks, financial account statements, and other documentary evidence.

### III. MISCELLANEOUS ITEMIZED DEDUCTIONS

You can no longer claim any miscellaneous itemized deductions that are subject to the 2% of adjusted gross income limitation, including unreimbursed employee expenses. However, you may be able to deduct certain unreimbursed employee business expenses if you fall into one of the following categories of employment listed under *Unreimbursed Employee Expenses*, next.

#### UNREIMBURSED EMPLOYEE EXPENSES

You can no longer claim a deduction for unreimbursed employee expenses unless you fall into one of the following categories of employment.

- Armed Forces reservists.
- Qualified performing artists.
- Fee-basis state or local government officials.
- Employees with impairment-related work expenses.

#### CATEGORIES OF EMPLOYMENT

You can deduct unreimbursed employee expenses only if you qualify as an Armed Forces reservist, qualified performing artist, fee-basis state or local government official, and employee with impairment-related work expenses.

**Armed Forces reservist (member of a reserve component).** You are a member of a reserve component of the Armed Forces of the United States if you are in the Army, Navy, Marine Corps, Air Force, or Coast Guard Reserve; the Army National Guard of the United States; or the Reserve Corps of the Public Health Service.

**Qualified performing artist.** You are a qualified performing artist if you:

1. Performed services in the performing arts as an employee for at least two employers during the tax year,
2. Received from at least two of the employers' wages of \$200 or more per employer,
3. Had allowable business expenses attributable to the performing arts of more than 10% of gross income from the performing arts, and
4. Had adjusted gross income of \$16,000 or less before deducting expenses as a performing artist.

**Fee-basis state or local government official.** You are a qualifying fee-basis official if you are employed by a state or political subdivision of a state and are compensated, in whole or in part, on a fee basis.

**Employee with impairment-related work expenses.** Impairment-related work expenses are the allowable expenses of an individual with physical or mental disabilities for attendant care at his or her place of employment. They also include other expenses in connection with the place of employment that enable the employee to work.

**Allowable unreimbursed employee expenses.** If you qualify as an employee in one of the categories mentioned above, you may be able to deduct the following items as unreimbursed employee expenses.

Unreimbursed employee expenses for individuals in these categories of employment are deducted as adjustments to gross income. Qualified employees listed in one of the categories above must complete Form 2106 to take the deduction.

You can deduct only unreimbursed employee expenses that are:

- Paid or incurred during your tax year,
- For carrying on your trade or business of being an employee, and
- Ordinary and necessary.

An expense is ordinary if it is common and accepted in your trade, business, or profession. An expense is necessary if it is appropriate and helpful to your business. An expense does not have to be required to be considered necessary.

## **EDUCATOR EXPENSES**

If you were an eligible educator in 2020, you can deduct up to \$250 of qualified expenses you paid in 2020 as an adjustment to gross income on Schedule 1 (Form 1040 or 1040-SR), line 10, rather than as a miscellaneous itemized deduction. If you and your spouse are filing jointly and both of you were eligible educators, the maximum deduction is \$500. However, neither spouse can deduct more than \$250 of his or her qualified expenses.

## **EXPENSES YOU CANNOT DEDUCT**

Because of the suspension of miscellaneous itemized deductions, there are two categories of expenses you cannot deduct: Miscellaneous itemized deductions subject to the 2% AGI limitation, and those expenses that are traditionally nondeductible under the Internal Revenue Code. Both categories of deduction are discussed next.

### **Miscellaneous Deductions Subject to 2% AGI**

Unless you fall into one of the qualified categories of employment under *Unreimbursed Employee Expenses*, earlier, miscellaneous itemized deductions that are subject to the 2% of adjusted gross income limitation can no longer be claimed. For expenses not related to unreimbursed employee expenses, you generally cannot deduct the following expenses, even if you fall into one of the qualified categories of employment listed earlier.

## **Appraisal Fees**

Appraisal fees you pay to figure a casualty loss or the fair market value of donated property are miscellaneous itemized deductions and can no longer be deducted.

## **Casualty and Theft Losses**

Damaged or stolen property used in performing services as an employee is a miscellaneous deduction and can no longer be deducted.

## **Clerical Help and Office Rent**

Office expenses, such as rent and clerical help, you pay in connection with your investments and collecting taxable income on those investments are miscellaneous itemized deductions and are no longer deductible.

## **Credit or Debit Card Convenience Fees**

The convenience fee charged by the card processor for paying your income tax (including estimated tax payments) by credit or debit card is a miscellaneous itemized deduction and is no longer deductible.

## **Depreciation on Home Computer**

If you use your home computer to produce income (for example, to manage your investments that produce taxable income), the depreciation of the computer for that part of the usage of the computer is a miscellaneous itemized deduction and is no longer deductible.

## **Excess Deductions of an Estate**

An excess deduction resulting from an estate's total deductions being greater than its gross income, in the previous tax year, is a miscellaneous itemized deduction and beneficiaries can no longer deduct it.

## **Fees To Collect Interest and Dividends**

Fees you pay to a broker, bank, trustee, or similar agent to collect your taxable bond interest or dividends on shares of stock are miscellaneous itemized deductions and can no longer be deducted.

## **Hobby Expenses**

A hobby is not a business because it is not carried on to make a profit. Hobby expenses are miscellaneous itemized deductions and can no longer be deducted.

## **Indirect Deductions of Pass-Through Entities**

Pass-through entities include partnerships, S corporations, and mutual funds that are not publicly offered. Deductions of pass-through entities are passed through to the partners or shareholders. The partners or shareholders share of passed-through deductions for investment expenses are miscellaneous itemized deductions and can no longer be deducted.

**Nonpublicly offered mutual funds.** These funds will send you a Form 1099-DIV, Dividends and Distributions, or a substitute form, showing your share of gross income and investment expenses. The investment expenses reported on Form 1099-DIV are a miscellaneous itemized deduction and are no longer deductible.

## **Investment Fees and Expenses**

Investment fees, custodial fees, trust administration fees, and other expenses you paid for managing your investments that produce taxable income are miscellaneous itemized deductions and are no longer deductible.

## **Legal Expenses**

You usually can deduct legal expenses that you incur in attempting to produce or collect taxable income or that you pay in connection with the determination, collection, or refund of any tax.

Legal expenses that you incur in attempting to produce or collect taxable income, or that you pay in connection with the determination, collection, or refund of any tax are miscellaneous itemized deductions and are no longer deductible.

You can deduct expenses of resolving tax issues relating to profit or loss from business (Schedule C), rentals or royalties (Schedule E), or farm income and expenses (Schedule F) on the appropriate schedule. Expenses for resolving nonbusiness tax issues are miscellaneous itemized deductions and are no longer deductible.

## **Loss on Deposits**

For information on whether, and if so, how, you may deduct a loss on your deposit in a qualified financial institution.

## **Repayments of Income**

Generally, repayments of amounts that you included in income in an earlier year is a miscellaneous itemized deduction and can no longer be deducted. If you had to repay more than \$3,000 that you included in your income in an earlier year, you may be able to deduct the amount. See *Repayments Under Claim of Right*, later.

## **Repayments of Social Security Benefits**

For information on how to deduct your repayments of certain social security benefits, see course *3111B*.

## **Safe Deposit Box Rent**

Rent you pay for a safety deposit box you use to store taxable income-producing stocks, bonds, or investment related papers is a miscellaneous itemized deduction and can no longer be deducted. You cannot deduct the rent if you use the box only for jewelry, other personal items, or tax-exempt securities.

## **Service Charges on Dividend Reinvestment Plans**

Service charges you pay as a subscriber in a dividend reinvestment plan are a miscellaneous itemized deduction and can no longer be deducted. These service charges include payments for:

- Holding shares acquired through a plan,
- Collecting and reinvesting cash dividends, and
- Keeping individual records and providing detailed statements of accounts.

## **Tax Preparation Fees**

Tax preparation fees on the return for the year in which you pay them are a miscellaneous itemized deduction and can no longer be deducted. These fees include the cost of tax preparation software programs and tax publications. They also include any fee you paid for electronic filing of your return.

## **Trustee's Administrative Fees for IRA**

Trustee's administrative fees that are billed separately and paid by you in connection with your IRA are a miscellaneous itemized deduction and can no longer be deducted. For more information about IRAs, see course *3114B*

# **IV. NONDEDUCTIBLE EXPENSES**

In addition to the miscellaneous itemized deductions discussed earlier, you cannot deduct the following expenses.

## **LIST OF NONDEDUCTIBLE EXPENSES**

- Adoption expenses.
- Broker's commissions.
- Burial or funeral expenses, including the cost of a cemetery lot.
- Campaign expenses.
- Capital expenses.
- Check-writing fees.
- Club dues.
- Commuting expenses.
- Fees and licenses, such as car licenses, marriage licenses, and dog tags.
- Fines or penalties.

- Health spa expenses.
- Hobby losses, but see *Hobby Expenses*, earlier.
- Home repairs, insurance, and rent.
- Home security system.
- Illegal bribes and kickbacks.
- Investment-related seminars.
- Life insurance premiums paid by the insured.
- Lobbying expenses.
- Losses from the sale of your home, furniture, personal car, etc.
- Lost or misplaced cash or property.
- Lunches with co-workers.
- Meals while working late.
- Medical expenses as business expenses other than medical examinations required by your employer.
- Personal disability insurance premiums.
- Personal legal expenses.
- Personal, living, or family expenses.
- Political contributions.
- Professional accreditation fees.
- Professional reputation, expenses to improve.
- Relief fund contributions.
- Residential telephone line.
- Stockholders' meeting, expenses of attending.
- Tax-exempt income, expenses of earning or collecting.
- The value of wages never received or lost vacation time.
- Travel expenses for another individual.
- Voluntary unemployment benefit fund contributions.
- Wristwatches.

## **Adoption Expenses**

You cannot deduct the expenses of adopting a child, but you may be able to take a credit for those expenses. See course *3119B*.

## **Campaign Expenses**

You cannot deduct campaign expenses of a candidate for any office, even if the candidate is running for reelection to the office. These include qualification and registration fees for primary elections.

**Legal fees.** You cannot deduct legal fees paid to defend charges that arise from participation in a political campaign.

## **Check-Writing Fees on Personal Account**

If you have a personal checking account, you cannot deduct fees charged by the bank for the privilege of writing checks, even if the account pays interest.

## **Club Dues**

Generally, you cannot deduct the cost of membership in any club organized for business, pleasure, recreation, or other social purpose. This includes business, social, athletic, luncheon, sporting, airline, hotel, golf, and country clubs.

You cannot deduct dues paid to an organization if one of its main purposes is to:

- Conduct entertainment activities for members or their guests, or
- Provide members or their guests with access to entertainment facilities.

Dues paid to airline, hotel, and luncheon clubs are not deductible.

## **Commuting Expenses**

You cannot deduct commuting expenses (the cost of transportation between your home and your main or regular place of work). If you haul tools, instruments, or other items in your car to and from work, you can deduct only the additional cost of hauling the items such as the rent on a trailer to carry the items.

## **Fines and Penalties**

Generally, no deduction is allowed for fines and penalties paid to a government or specified nongovernmental entity for the violation of any law except in the following situations.

- Amounts that constitute restitution.
- Amounts paid to come into compliance with the law.
- Amounts paid or incurred as the result of certain court orders in which no government or specified nongovernmental agency is a party.

- Amounts paid or incurred for taxes due.

Nondeductible amounts include an amount paid in settlement of your actual or potential liability for a fine or penalty (civil or criminal). Fines or penalties include amounts paid such as parking tickets, tax penalties, and penalties deducted from teachers' paychecks after an illegal strike.

Beginning on December 22, 2017, no deduction is allowed for the restitution amount or amount paid to come into compliance with the law unless the amounts are specifically identified in the settlement agreement or court order. Also, any amount paid or incurred as reimbursement to the government for the costs of any investigation or litigation are not eligible for the exceptions and are nondeductible.

### **Health Spa Expenses**

You cannot deduct health spa expenses, even if there is a job requirement to stay in excellent physical condition, such as might be required of a law enforcement officer.

### **Home Security System**

You cannot deduct the cost of a home security system as a miscellaneous deduction. However, you may be able to claim a deduction for a home security system as a business expense if you have a home office.

### **Investment-Related Seminars**

You cannot deduct any expenses for attending a convention, seminar, or similar meeting for investment purposes.

### **Life Insurance Premiums**

You cannot deduct premiums you pay on your life insurance. You may be able to deduct, as alimony, premiums you pay on life insurance policies assigned to your former spouse. See courses *3114B* for information on alimony.

### **Lobbying Expenses**

You generally cannot deduct amounts paid or in-curred for lobbying expenses. These include expenses to:

- Influence legislation;
- Participate or intervene in any political campaign for, or against, any candidate for public office;
- Attempt to influence the general public, or segments of the public, about elections, legislative matters, or referendums; or

- Communicate directly with covered executive branch officials in any attempt to influence the official actions or positions of those officials.

Lobbying expenses also include any amounts paid or incurred for research, preparation, planning, or coordination of any of these activities.

***Dues used for lobbying.*** If a tax-exempt organization notifies you that part of the dues or other amounts you pay to the organization are used to pay nondeductible lobbying expenses, you cannot deduct that part.

### **Lost or Mislaid Cash or Property**

You cannot deduct a loss based on the mere disappearance of money or property. However, an accidental loss or disappearance of property can qualify as a casualty if it results from an identifiable event that is sudden, unexpected, or unusual. See *3117B*.

### **Lunches With Co-workers**

You cannot deduct the expenses of lunches with co-workers, except while traveling away from home on business. See chapter 20 for information on deductible expenses while traveling away from home.

### **Meals While Working Late**

You cannot deduct the cost of meals while working late. However, you may be able to claim a deduction if the cost of meals is a deductible entertainment expense, or if you're traveling away from home. See course *3115B* for information on deductible entertainment expenses and expenses while traveling away from home.

### **Personal Legal Expenses**

You cannot deduct personal legal expenses such as those for the following.

- Custody of children.
- Breach of promise to marry suit.
- Civil or criminal charges resulting from a personal relationship.
- Damages for personal injury, except for certain unlawful discrimination and whistle-blower claims.
- Preparation of a title (or defense or perfection of a title).
- Preparation of a will.
- Property claims or property settlement in a divorce.

You cannot deduct these expenses even if a result of the legal proceeding is the loss of income-producing property.

## **Political Contributions**

You cannot deduct contributions made to a political candidate, a campaign committee, or a newsletter fund. Advertisements in convention bulletins and admissions to dinners or programs that benefit a political party or political candidate aren't deductible.

## **Professional Accreditation Fees**

You cannot deduct professional accreditation fees such as the following.

- Accounting certificate fees paid for the initial right to practice accounting.
- Bar exam fees and incidental expenses in securing initial admission to the bar.
- Medical and dental license fees paid to get initial licensing.

## **Professional Reputation**

You cannot deduct expenses of radio and TV appearances to increase your personal prestige or establish your professional reputation.

## **Relief Fund Contributions**

You cannot deduct contributions paid to a private plan that pays benefits to any covered employee who cannot work because of any injury or illness not related to the job.

## **Residential Telephone Service**

You cannot deduct any charge (including taxes) for basic local telephone service for the first telephone line to your residence, even if it is used in a trade or business.

## **Stockholders' Meetings**

You cannot deduct transportation and other expenses you pay to attend stockholders' meetings of companies in which you own stock but have no other interest. You cannot deduct these expenses even if you are attending the meeting to get information that would be useful in making further investments.

## **Tax-Exempt Income Expenses**

You cannot deduct expenses to produce tax-exempt income. You cannot deduct interest on a debt incurred or continued to buy or carry tax-exempt securities.

If you have expenses to produce both taxable and tax-exempt income, but you cannot identify the expenses that produce each type of income, you must divide the expenses based on the amount of each type of income to determine the amount that you can deduct.

## Travel Expenses for Another Individual

You generally cannot deduct travel expenses you pay or incur for a spouse, dependent, or other individual who accompanies you (or your employee) on business or personal travel unless the spouse, dependent, or other individual is an employee of the taxpayer, the travel is for a bona fide business purpose, and such expenses would otherwise be deductible by the spouse, dependent, or other individual. See course 3115B for more information on deductible travel expenses.

## Voluntary Unemployment Benefit Fund Contributions

You cannot deduct voluntary unemployment benefit fund contributions you make to a union fund or a private fund. However, you can deduct contributions as taxes if state law requires you to make them to a state unemployment fund that covers you for the loss of wages from unemployment caused by business conditions.

## Wristwatches

You cannot deduct the cost of a wristwatch, even if there is a job requirement that you know the correct time to properly perform your duties.

# V. EXPENSES YOU CAN DEDUCT

You can deduct the items listed below as itemized deductions. Report these items on Schedule A (Form 1040 or 1040-SR), line 16, or Schedule A (Form 1040-NR), line 7.

## LIST OF DEDUCTIONS

Each of the following items is discussed in detail after the list (except where indicated).

- Amortizable premium on taxable bonds.
- Casualty and theft losses from income-producing property.
- Federal estate tax on income in respect of a decedent.
- Gambling losses up to the amount of gambling winnings.
- Impairment-related work expenses of persons with disabilities.
- Losses from Ponzi-type investment schemes. See *Losses from Ponzi-type investment schemes* under *Theft* in course 3117B.
- Repayments of more than \$3,000 under a claim of right.
- Unlawful discrimination claims.
- Unrecovered investment in an annuity.

## Amortizable Premium on Taxable Bonds

In general, if the amount you pay for a bond is greater than its stated principal amount, the excess is bond premium. You can elect to amortize the premium on taxable bonds. The amortization of the premium is generally an offset to interest income on the bond rather than a separate deduction item.

Part of the premium on some bonds may be an itemized deduction on Schedule A (Form 1040 or 1040-SR).

## Casualty and Theft Losses of Income-Producing Property

You can deduct a casualty or theft loss as an itemized deduction on Schedule A (Form 1040 or 1040-SR), line 16, if the damaged or stolen property was income-producing property (property held for investment, such as stocks, notes, bonds, gold, silver, vacant lots, and works of art). First, report the loss in Form 4684, Section B. You may also have to include the loss on Form 4797, if you are otherwise required to file that form. To figure your deduction, add all casualty or theft losses from this type of property included on Form 4684, lines 32 and 38b, or Form 4797, line 18a. For more information on casualty and theft losses, see course 3117B.

## Federal Estate Tax on Income in Respect of a Decedent

You can deduct the federal estate tax attributable to income in respect of a decedent that you as a beneficiary include in your gross income. Income in respect of the decedent is gross income that the decedent would have received had death not occurred and that was not properly includible in the decedent's final income tax return.

## Gambling Losses up to the Amount of Gambling Winnings

You must report the full amount of your gambling winnings for the year on Schedule 1 (Form 1040 or 1040-SR), line 8. You deduct your gambling losses for the year on Schedule A (Form 1040 or 1040-SR), line 16. You cannot deduct gambling losses that are more than your winnings.

### Caution!



You cannot reduce your gambling winnings by your gambling losses and report the difference. You must report the full amount of your winnings as income and claim your losses (up to the amount of winnings) as an itemized deduction. Therefore, your records should show your winnings separately from your losses.

## Tip



**Diary of winnings and losses.** You must keep an accurate diary or similar record of your losses and winnings.

Your diary should contain at least the following information.

- The date and type of your specific wager or wagering activity.
- The name and address or location of the gambling establishment.
- The names of other persons present with you at the gambling establishment.
- The amount(s) you won or lost.

### Impairment-Related Work Expenses

If you have a physical or mental disability that limits your being employed, or substantially limits one or more of your major life activities, such as performing manual tasks, walking, speaking, breathing, learning, and working, you can deduct your impairment-related work expenses.

Impairment-related work expenses are ordinary and necessary business expenses for attendant care services at your place of work and for other expenses in connection with your place of work that are necessary for you to be able to work.

**Self-employed.** If you are self-employed, enter your impairment-related work expenses on the appropriate form (Schedule C, E, or F) used to report your business income and expenses.

### Repayments Under Claim of Right

If you had to repay more than \$3,000 that you included in your income in an earlier year because at the time you thought you had an unrestricted right to it, you may be able to deduct the amount you repaid or take a credit against your tax. See Repayments in course *3112B* for more information.

### Unlawful Discrimination Claims

You may be able to deduct, as an adjustment to income on Schedule 1 (Form 1040 or 1040-SR), line 22, or Form 1040-NR, line 35, attorney fees and court costs for actions settled or decided after October 22, 2004, involving a claim of unlawful discrimination, a claim against the U.S. Government, or a claim made under section 1862(b)(3)(A) of the Social Security Act. However, the amount you can deduct on Schedule 1 (Form 1040 or 1040-SR), line 22, or Form 1040-NR, line 35, is limited to the amount of the judgment or settlement you are including in income for the tax year.

## **Unrecovered Investment in Annuity**

A retiree who contributed to the cost of an annuity can exclude from income a part of each payment received as a tax-free return of the retiree's investment. If the retiree dies before the entire investment is recovered tax free, any unrecovered investment can be deducted on the retiree's final income tax return. See courses *3112B* for more information about the tax treatment of pensions and annuities.

## CHAPTER 1: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	<p><b>All of the following categories of employment can continue to claim a deduction for unreimbursed employee expenses post the passage of the TCJA <u>except</u>:</b></p> <ul style="list-style-type: none"><li>A. Armed Forces reservists</li><li>B. qualified performing artists</li><li>C. nonprofit organization employees</li><li>D. fee-basis state or local government officials</li></ul>
2.	<p><b>In order for employees in certain categories of employment to deduct unreimbursed employee expenses, the expenses must be which of the following:</b></p> <ul style="list-style-type: none"><li>A. ordinary</li><li>B. necessary</li><li>C. lavish</li><li>D. both A and B above</li></ul>

## CHAPTER 1: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	<p><b>A.</b> Incorrect. You are a member of a reserve component of the Armed Forces if you are in the Army, Navy, Marine Corps, Air Force, or Coast Guard Reserve; the Army National Guard; or the Reserve Corps of the Public Health Service.</p> <p><b>B.</b> Incorrect. You are a qualified performing artist if you performed services in the performing arts as an employee for at least two employers during the tax year, received at least two of the employer's wages of \$200 or more per employer, had allowable business expenses attributable to the performing arts of more than 10% of gross income from the performing arts, and had adjusted gross income of \$16,000 or less before deducting expenses as a performing artist.</p> <p><b>C.</b> <b>CORRECT.</b> Nonprofit organization employees are not among the categories listed by the IRS.</p> <p><b>D.</b> Incorrect. You are a qualifying fee-basis official if you are employed by a state or political subdivision of a state and are compensated, in whole or in part, on a fee basis.</p>
2.	<p><b>A.</b> Incorrect. An expense is ordinary if it is common and accepted in your trade, business, or profession. However, this is not the best response.</p> <p><b>B.</b> Incorrect. An expense is necessary if it is appropriate and helpful to your business. However, this is not the best response.</p> <p><b>C.</b> Incorrect. Lavish expenses are not considered deductible.</p> <p><b>D.</b> <b>CORRECT.</b> Unreimbursed employee expenses can only be deducted if they are paid or incurred during the taxpayer's tax year, for carrying on the taxpayer's trade or business of being an employee, and ordinary and necessary.</p>

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# CHAPTER 2: SECTION 199A PASS-THROUGH INCOME DEDUCTION

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## Chapter Objective

### After completing this chapter, you should be able to:

- Identify the rules in the TCJA related to claiming a deduction for “qualified business income.”

**Note:** This chapter has been updated with the Final Regulations and Other IRS Guidance issued by the IRS in January 2019 and inflation adjusted numbers for 2020.

## I. QUALIFIED BUSINESS INCOME

Probably the most complex and far-reaching rule contained in the TCJA is the ability to claim a deduction for “qualified business income.” This rule, contained in Code Section 199A, permits proprietors, partners and S corporation shareholders to claim a deduction for up to 20% of the taxable income from their enterprises. This new deduction is termed the “Section 199A deduction” or the “QBI deduction.”

The American Jobs Creation Act of 2004 had added a deduction for Income Attributable to Domestic Production Activities. [Code Sec. 199] This rule allowed a deduction for certain income of various domestic production activities – up to 9% of taxable income. To allay some concerns about exportation of jobs, this deduction was limited to 50% of the W-2 wages paid in a taxable year. Thus, outsourcing of jobs could mean the loss of part of the base for the deduction. The Tax Cuts and Jobs Act repealed this deduction, but retained the 50% of W-2 wage rule for the QBI deduction. To accommodate real estate enterprises, which do not always have significant W-2 wage payments, Section 199A provides an alternate test using the basis of depreciable property.

As of 2018, two tax savings mechanisms replace the former Section 199, Domestic Production Activities Deduction:

1. Reduction of the C corporation rate to 21%; and
2. A special deduction for noncorporate taxpayers for qualified business income (QBI).

However, the Further Consolidated Appropriations Act, 2018 [P.L. 115-141] restored the rules of former Section 199 for cooperatives. [P.L. 115-141, Sec. 101(b)(2)(A), Div. T]

## DEDUCTION FOR QUALIFIED BUSINESS INCOME (QBI)

Code Section 199A permits a deduction for 20% of certain income from partnerships, proprietorships and S corporations. It also applies to dividends from real estate investment trusts (REITs), income from publicly-traded partnerships (PTPs) and certain payments from cooperatives (COOPs) to their patrons.

The deduction is 20% of the qualifying income, but is limited to 20% of the individual's taxable income, reduced for items taxed as net capital gains (long-term capital gains and qualified dividends). [Code Sec. 199A(a)(1)(B)] The deduction is taken below AGI, although it is available in full for taxpayers who itemize or those who use the standard deduction. [Code Sec. 63(b)(3)]

The rules for income from Real Estate Investment Trusts (REITs) and Publicly Traded Partnerships (PTPs) are straightforward. Commercial businesses, professional service businesses and farms are subject to the most complex rules described below.

- The rules require separate computations for each separate trade or business;
- The income and other items must be effectively connected with a U.S. trade or business;
- There are special rules based on the taxpayer's taxable income (before the § 199A deduction);
- Wage, salary and retirement income are not components of QBI;
- Dividends, including qualified dividends, are not components of QBI;
- Capital gains and losses do not directly enter into the computation of QBI, but these items may affect the ultimate deduction.

## Comment



The QBI deduction was written hastily, and was amended several times between its initial exposure in the Senate draft bill and the product that ultimately became law. The various drafters omitted detailed rules which may be necessary to apply the law in its intended manner. Some of these might take the form of technical corrections or other statutory changes down the road. However, the IRS has specific and broad regulatory authority to interpret Section 199A. [Code Sec. 199A(f)(4)] Therefore, its interpretations will have substantial weight of authority and will not be easy to challenge successfully. The Consolidated Appropriations Act, 2018 has already amended rules concerning cooperatives and their patrons. More corrections are to be expected. This deduction is one of the rules for which the IRS expects to issue much guidance.

## INCOME FROM REITS AND PTPS

A REIT is a domestic corporation, or association treated as a corporation for federal tax purposes, which qualifies and elects to be treated as a REIT. [Code Sec. 856] Substantially all of its income and assets must be connected with real estate. It must have 100 or more owners and cannot be controlled by a small group. It must distribute at least 90% of its taxable income.

A REIT is taxable as a corporation, except that it deducts the dividends paid to its owners. The owners include the dividends from the REIT as gross income. Some of the dividends may be treated as capital gains and others as ordinary income. [Code Sec. 857]

## Comment



REITs are subject to several complex rules as to permissible income, assets and activities. These rules are beyond the scope of this Guide, and are found in Code Sections 856–860.

A PTP exists when interests in the partnership are traded on an established securities market or secondary market. [Code Sec. 7704(b)] A PTP is treated as a corporation unless 90% or more of its gross income is from “passive-type” sources. [Code Sec. 7704(c)] These sources are interest, dividends, real property rents, gains from the disposition of real property, income from oil, gas, mineral and other natural resources, and gains from disposition of any assets used in these income-producing activities. [Code Sec. 7704(d)] There are special rules relating to commodities.

A distribution from a REIT to an individual is not QBI, per se. [Code Sec. 199A(c)(1)] However, a distribution from a REIT qualifies for the 20% deduction if it is not treated as a capital gain or qualified dividend. [Code Sec. 199A(b)(1)(B), 199A(e)(3)] Similarly, an individual’s share of income from a PTP is not QBI, although it qualifies for the 20% deduction.

The shareholder deduction for QBI from a REIT or PTP does not depend on the W-2 wages or qualified property of the entity. However, a PTP must have qualifying income from a U.S. trade or business. A PTP may have items of income and gain that do not qualify for the QBI deduction. As a reporting entity, a PTP must inform its partners about the income items that do qualify for this deduction.

Gains from dispositions of interests in REITs and PTPs are generally capital gains. However, if a PTP has unrealized receivables or substantially appreciated inventory items, some or all of the gain on the disposition of an interest in a partnership may be ordinary income. [Code Sec. 751(a)] Ordinary income resulting from the disposition of a PTP qualifies for the QBI deduction.

## Comment



Given the requirements for the income and assets of a qualifying PTP, it is unlikely that unrealized receivables and substantially appreciated inventory items would be a significant portion of the partnership’s assets. Therefore, it is unlikely that many gains from the disposition of interests in these entities will be treated as ordinary income.

The deduction for income from a REIT or PTP is the easiest to compute. There is no reference to W-2 wages, qualified property or the taxpayer’s taxable income, except for the overall limit. The deduction is

the lesser of 20% of the REIT or PTP income or 20% of the individual's taxable income (excluding gains and dividends taxed at capital gain rates).

## Example 1



Jeannie, a single individual, has the following income in 2020:

Salary	\$100,000
Dividends from REITs (ordinary income)	50,000
Income from PTPs	40,000
AGI	\$190,000

Her itemized deductions are \$31,000. Thus, her taxable income is \$159,000, before any QBI deduction. She calculates her base for the QBI deduction as the lesser of:

Income from REITs and PTPs	\$90,000	
Tentative deduction	20%	18,000
Taxable income:		
AGI	190,000	
Less itemized deductions	(31,000)	
Taxable income pre QBI	159,000	
Tentative deduction	20%	31,800
Lesser amount		18,000
199A Deduction		\$18,000

When some of the taxable income is taxed as a net capital gain there is another limitation. Since capital gain tax rates already provide an advantage over ordinary income, this amount of taxable income reduces the base for the QBI deduction. [Code Sec. 199A(2)(B)]

## Example 2



Merle, a single individual, has the following income in 2020:

Qualified dividends	\$100,000
Dividends from REITs	50,000
Income from PTPs	40,000
AGI	\$190,000

His itemized deductions are \$31,000. Thus, his taxable income before the QBI deduction is \$159,000, the same amount reported by Jeannie in Example 1. He calculates his base for the QBI deduction as the lesser of:

## Example 2 (continued)



Income from REITs and PTPs	\$90,000	
Tentative deduction	20%	18,000
Taxable income:		
AGI	190,000	
Less itemized deductions	(31,000)	
Taxable income pre QBI	159,000	
Less net capital gain	(100,000)	
Taxable income limitation	59,000	
Tentative deduction	20%	11,800
Lesser amount		11,800
199A Deduction		\$11,800

### INCOME FROM SOURCES OTHER THAN REITS AND PTPS

For business income other than from REITs and PTPs, there are several requirements, some of which depend upon the taxpayer's level of income. Rules that do not fluctuate with the taxpayer's income level include:

- The income must be effectively connected with a U.S. trade or business; [Code Sec. 199A(c)(3)(A)(i)]
- Certain income is not QBI, even if it is effectively connected with a U.S. trade or business; [Code Sec. 199A(c)(3)(B)]
- Each taxpayer must compute a separate deduction for each trade or business. [Code Sec. 199A(b)(2)]

Provisions that vary with the taxpayer's income are:

- The deduction is generally limited to 20% of the taxable income if taxable income is less than the taxpayer's QBI. [Code Sec. 199A(a)(1)(B)(i)]
- Income from a specified service business may or may not be part of the base for the QBI deduction, depending on the amount of taxable income and the taxpayer's filing status. [Code Sec. 199A(d)(1)(A), 199A(d)(3)]
- For a business other than specified service activity, the deduction may or may not depend on W-2 wages paid by the taxpayer or qualified property held by the taxpayer, depending on the amount of taxable income and the taxpayer's filing status. [Code Sec. 199A(b)(2)]

## **EFFECTIVELY CONNECTED WITH TRADE OR BUSINESS WITHIN U.S.**

To be QBI, the income must be effectively connected with a U.S. trade or business. [Code Sec. 199A(c)(3)(A)(i)] This rule borrows from Code Section 864(c), in Subchapter N, *Tax Based on Income from Sources Within or Without the United States*.

The U.S. place of business is also a material factor if it is used for management of U.S. sales, rents or royalties. [Reg. § 1.864-6(b)(2)] Thus, rentals and royalties from U.S. property are clearly within this requirement. Any business conducted in Puerto Rico is treated as a U.S. trade or business for this purpose. [Code Sec. 199A(f)(1)(C)(i)]

Section 864(c) contains several rules applicable to foreign persons and entities and most of its language is concerned with what is not U.S. source income. The principal test is based on having an office or other fixed place of business within the U.S., if the place is a material factor in the realization of the income, gain, or loss, and if the income, gain, or loss is realized in the ordinary course of the trade or business carried on through that office or other fixed place of business. [Reg. § 1.864-6(b)(1)]

## **INCOME NOT TREATED AS QUALIFIED BUSINESS INCOME**

Certain income is not QBI, even if it is effectively connected with a U.S. trade or business. [Code Sec. 199A(c)(3)(B)]

These items include:

- Long-term and short-term capital gains and losses;
- Dividends and equivalents (other than patronage dividends from cooperatives);
- Interest (other than that properly allocable to a trade or business); and
- Annuities (unless properly allocable to a trade or business).

In addition, wage or salary income received from the activity does not constitute QBI for an S corporation shareholder-employee. [Code Sec. 199A(c)(4)(A)] Similarly, guaranteed payments received by a partner, as well as any amounts received by a partner in a nonpartner capacity do not count as QBI. [Code Sec. 199A(c)(4)(B), (C)]

### Example 3



Sandy and Paul are the sole and equal shareholders of Sapco, an S corporation. Sandy is the president and active manager of the corporation's business. Paul, her brother, lives in another state and is a passive investor. All of the business income in 2020 is QBI. The net income, after payment of Sandy's \$200,000 salary, is \$600,000. There are no other employees of Sapco. Sandy and Paul would each treat \$300,000 as qualified business income and would each treat their portions of Sandy's salary as qualifying W-2 wages (see discussion below). Therefore, assuming that both shareholders had taxable income in excess of the threshold and phaseout limits, they could claim a QBI deduction of \$50,000, the lesser of 20% of QBI or 50% of their allocable W-2 wages. Sandy cannot claim any of her salary as QBI.

### Example 4



Assume the same facts in Example 3 except that Sapco is a limited liability company, treated as a partnership for federal income tax purposes. Sandy's compensation is a guaranteed payment for services. Since guaranteed payments are not reported on Form W-2, Sapco has no qualifying W-2 wages. If the partners are above the threshold and phaseout ranges, they cannot claim any QBI deduction.

These rules do not restrict QBI to ordinary income, *per se*. As a matter of fact, due to the incorporation of the Section 864 rules, gains from sales of property used in a U.S. trade or business are not excluded from QBI.

### Example 5



Salty, an S corporation realized \$85,000 of ordinary income in 2020. It also sold some business assets, resulting in a \$25,000 depreciation recapture and \$45,000 of Section 1231 gain from the sale of depreciated real estate. Salty also reported interest and dividend income of \$10,000 from portfolio investments. Salty has no sources of income from outside the U.S.

The ordinary income and the depreciation recapture are taxable at ordinary income rates. Thus, if any shareholder is at the highest income bracket, and has sufficient taxable income to deduct the entire 20% from Salty, the effective tax rate on this income is 29.6% ( $80\% \times 37\%$ ). Assuming that the Section 1231 gain is not converted to ordinary income by the five-year lookback rule, it is not treated as part of QBI.

## Example 5 (continued)



Sally, the sole shareholder of Salty, has no Section 1231 losses in the current or past five years. Her Section 1231 gain is not QBI. She computes her QBI from Salty as:

Ordinary income	\$85,000
Depreciation recapture	<u>25,000</u>
QBI	<u>\$110,000</u>

### TAXABLE INCOME THRESHOLD RULES

Some of the most important tax planning needs to focus on increasing or decreasing taxable income to get certain results for the QBI deduction. Important limits apply to individual taxpayers, based on their level of taxable income.

- If taxable income is below a certain threshold, income from specified services constitutes qualified business income. If the income is above the threshold, this income does not qualify for the QBI deduction.
- If income is below the threshold, the deduction for income from a trade or business other than a specified service activity is not dependent upon the W-2 wages paid by the business or the qualified property held by the business. If the taxpayer's income exceeds the threshold, the deduction for QBI is limited by one or both of these factors.

When income exceeds the threshold, there is a phaseout range. When taxable income exceeds the threshold, but is within the phaseout range, the limits apply in part. When taxable income exceeds the threshold plus the phaseout range, the limits apply in full. The threshold rules depend on the taxpayer's filing status. [Code Sec. 199A(e)(2)]. The thresholds, but not the phaseout ranges, are indexed after 2018.

**TABLE 28-1. THRESHOLDS FOR PHASE-IN OF LIMITATIONS (2020)**

Filing Status	All Except Married Filing Joint	Married Filing Joint
Threshold	\$163,300	\$326,600
Phaseout for wage and property limit [Code Sec. 199A(b)(3)(B)] and service income [Code Sec. 199A(d)(3)]	50,000	100,000
End of phaseout	\$213,300	\$426,600

## SEPARATE COMPUTATION FOR EACH TRADE OR BUSINESS

Code Section 199A requires a separate computation of the income and other limits for each qualified trade or business. [Code Sec. 199A(b)(1)(A), Code Sec. 199A(c)(1)] Accordingly, a taxpayer with more than one trade or business may not mix the income of one activity with the W-2 wages or qualified property of another.

Determination of what constitutes a separate trade or business will be problematic for planning and compliance with the new deduction. In some cases, taxpayers may want to separate certain activities, especially when one activity is a specified service business, and another is not.

In other cases, taxpayers will want to combine business ventures so that the income from one enterprise can draw upon the W-2 wages or qualified property of another.

### Aggregation of Multiple Trades or Businesses

The Code does not specify rules for aggregation and separation. According to the regulations, each business activity must be treated as a separate trade or business unless aggregation is permitted. [Reg. §1.199A-4(a)] The regulations contain some specific aggregation rules. A pass-through entity that conducts more than one business may aggregate, if the businesses meet the ownership and business relationship rules and if none of the businesses to be aggregated are specified service trades or businesses (SSTBs). If a pass-through entity elects to aggregate businesses, each partner or shareholder is bound by the aggregation of those particular businesses.

Each partner or shareholder may also be allowed to aggregate activities. This aggregation could include businesses conducted by one or more S corporations or partnerships, even if the entities did not elect to aggregate. However, in order to aggregate, all of the owners' aggregate activities must meet the ownership and business relationship tests as discussed below.

### The Ownership Tests

There are three basic rules governing the ownership tests.

1. In order to aggregate, a person, entity, or group must own at least 50% of each trade or business. [Reg. §1.199A-4(b)(1)(i)] The ownership must be outright ownership of the entire activity, stock (in S corporations) and capital or profits interest (in partnerships).
2. There must be common ownership for a majority of the taxable year in question. [Reg. §1.199A-4(b)(1)(ii)]
3. All of the businesses must use the same taxable year, not including short years. [Reg. §1.199A-4(b)(1)(iii)]

A taxpayer uses the rules of Code Sections 267(b) and 707(b) to determine constructive ownership for purposes of the aggregation rules. [Reg. §1.199A-4(b)(1)(i)]

## The Business Relationship Tests

Each of the eligible businesses must share at least two of these attributes with the others:

1. The products or services must be the same or complementary;
2. The businesses must share the same facilities or business functions such as accounting, and payroll, advertising, etc.; and
3. There must be interdependence between (or among) the businesses. [Reg. §1.199A-4(b)(1)(v)]

## Aggregation Election by Pass-Through Entity

The primary burdens on the pass-through entity in this situation are reporting income, deductions, gains, losses, etc., to shareholders and accounting for separate and combined lines of business. The burdens of disallowance, and the benefits of deducting suspended losses, fall entirely on the owners.

Once a pass-through entity makes a grouping election, the owners must group those activities with each other, with activities conducted directly by the taxpayer, or with activities conducted through other S corporations or partnerships, in accordance with the same criteria. [Reg. §1.199A-4(b)(2)(ii)]

### Example 6



Green, LLC has several partners. Green owns and operates a highway center. The center has a gas and diesel station, a convenience store and a fast food franchise. Each of these businesses has separate books and records. If Green treats these enterprises as separate activities, each of the owners may group the income or loss from each enterprise with income or loss from other enterprises of a similar nature, assuming that the other activities meet all tests for aggregation with Green's businesses. If Green aggregates the three as a single business, no shareholder will be able to disaggregate the grouping.

## Aggregation by Shareholder or Partner

A shareholder or partner may not treat activities owned by a pass-through entity as separate activities if the entity has grouped them together. However, the owners may group certain activities together. This could be useful when combining attributes of separate activities could match income with one venture with W-2 wages paid by another activity or with the qualified property owned by an enterprise under common control. See discussion of these limits below.

## Example 7



Sally and Vic are married and file a joint return. Vic is the sole shareholder of Vic's Market, an S corporation that operates a grocery store. Sally is the sole shareholder of J Co., which owns a building and rents it to Vic's Market. This arrangement has been in effect for the entire taxable year. Under Code Section 267(b), Sally and Vic are each treated as the owner of each other's property. Therefore, the rental and grocery meet the ownership test required for aggregation. The store and the building are also interdependent. They are also at the same location. Therefore, Vic and Sally can aggregate the rental and the grocery operation.

The net income from the market and the net income from the rent would be treated as QBI from one business. Sally and Vic would also be able to use the qualified property limit from the rental as one of the factors determining the deduction for the income of the combined entity.

### SPECIFIED SERVICE TRADE OR BUSINESS RULES

Any taxpayer whose taxable income exceeds the threshold plus phaseout is not able to claim a deduction for income from a *"specified service trade or business."* This rule begins by borrowing a definition from Code Section 1202(e)(3)(A), but then makes some modifications. Section 1202(e)(3)(A) lists the following activities as being service businesses:

- Health
- Law
- Engineering (but see below for Section 199A)
- Architecture (but see below for Section 199A)
- 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 employees.

The regulations treat the reputation of owners or employees as the principal asset of an SSTB only under the following limited circumstances: [Reg. §1.199A-5(b)(2)(xiv)]

- Fees, compensation, or other income is received for endorsing products or services;
- Licenses or fees, compensation, or other income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity is received;
- Fees, compensation, or other income for appearing at an event or on radio, television, or another media format is received.

### Example 8



Ed's Eatery, Inc., an S corporation, owns a gourmet restaurant in an out of the way location. Since Ed's Eatery hired Esther Epicurean, a widely-renowned chef, it is booked every night of the week, and customers need to reserve tables several days in advance. Ed's Eatery is not treated as an SSTB.

Section 199A adds investing and investment management, trading, or dealing in securities, partnership interests, or commodities to the list of specified services. [Code Sec. 199A(d)(2)(B)]

However, Section 199A specifically excludes engineering and architecture. Thus, these professions are governed by the commercial business rules.

### TAXABLE INCOME DOES NOT EXCEED THRESHOLD

Taxpayers whose taxable income does not exceed the threshold described in Table 1 treat income from a specified service business as QBI. Thus, if a taxpayer's AGI less the standard deduction or itemized deductions does not exceed \$163,300 (\$326,600 for married filing joint returns), all of the specified service business income is QBI. [Code Sec. 199A(d)(3)(A)(i)]

### Example 9



Dino, a single individual, has the following income in 2020:

Qualified dividends	\$10,000
Income from law practice, sole practitioner	120,000
Other ordinary income, not from trade or business, rent or royalty	15,000
Self-employment tax deduction	(8,478)
AGI	\$145,000

Dino does not itemize deductions. Subtracting the standard deduction of \$12,400 from his AGI, his taxable income is \$132,600. He must determine whether or not his taxable income (before the Section 199A deduction) is under the threshold of \$163,300. [See

## Example 9 (continued)



Table 1, above] Since his income is less than the threshold, he treats all of his law practice income as QBI. He calculates his base for the QBI deduction as the lesser of:

Income from law practice, net of self-employment tax deduction	\$111,522	
Tentative deduction	20%	\$22,304
Taxable income:		
AGI	145,000	
Less standard deduction	(12,400)	
Taxable income pre QBI	124,122	
Less net capital gain	(10,000)	
Taxable income limitation	114,122	
Tentative deduction	20%	22,824
Lesser amount		22,304
Deduction		\$22,304

Dino's taxable income is:

Adjusted gross income		\$136,522
Standard deduction		(12,400)
QBI deduction		(22,304)
Taxable income		\$101,818

### TAXABLE INCOME EXCEEDS THRESHOLD PLUS PHASEOUT

When a person's taxable income exceeds the threshold limit of \$163,300 (\$326,600 for married filing joint return) plus the phaseout range of \$50,000 (\$100,000 for married filing joint return), none of the income from a specified service business is QBI.

## Example 10



Assume the same facts in Example 9, except that Dino's income from his law practice is \$220,000. He has the following income in 2020:

Qualified dividends		\$10,000
Income from law practice, sole practitioner		220,000
Other ordinary income, not from trade or business, rent or royalty		15,000
Self-employment tax deduction		11,186
AGI		\$233,814

## Example 10 (continued)



Dino does not itemize deductions. Subtracting the standard deduction of \$12,400 from his AGI, his taxable income is \$221,414. He must determine whether or not his taxable income (before the Section 199A deduction) is under the threshold of \$163,300 plus the \$50,000 phaseout, or \$213,300. [See Table 1] Since his income exceeds the threshold plus the phaseout range, none of his law practice income is QBI. Dino's taxable income is:

Adjusted gross income	\$233,814
Standard deduction	(12,400)
QBI deduction	0
Income	\$221,414

In this case, the increase of \$100,000 of gross income, when comparing Example 10 and Example 9, created \$119,596 of additional taxable income (\$221,414 - 101,818) resulting from the loss of the QBI deduction.

### TAXABLE INCOME EXCEEDS THRESHOLD BUT IS WITHIN PHASEOUT RANGE

When a person's taxable income exceeds the threshold limit of \$163,300 (\$326,600 for married filing joint return, or \$163,300 for married filing separate return) but is within the phaseout range of \$50,000 (\$100,000 for married filing joint return), a portion of the income from a specified service business is QBI. To determine the percentage allowed as QBI, the taxpayer must back in from the amount disallowed. The amount disallowed is [Code Sec. 199A(d)(3)(B)]:

$$\frac{(\text{Taxable income less threshold})}{(\text{phaseout range})}$$

## Example 11



Assume the same facts in Example 9 except that Dino's income from his law practice is \$180,000. He has the following income in 2020:

Dividends	\$10,000
Income from law practice, sole practitioner	180,000
Other ordinary income, not from trade or business, rent or royalty	15,000
Self-employment tax deduction	(10,650)
AGI	\$194,350

## Example 11 (continued)



He does not itemize deductions. Thus, his taxable income is \$181,950 (\$194,350 – 12,400), before any allowable Section 199A deduction. His income from his law practice is subject to the specified service rules. Since his income exceeds the threshold but not the phaseout range he may treat a portion of his law practice income as QBI.

Taxable income before Section 199A deduction	\$181,950
Threshold	(163,300)
Excess	18,650
Phaseout range	50,000
Excess as % of phaseout range (\$21,450/50,000)	37.3%
Percent of deduction allowed	62.7%
Service before limit (\$180,000 - 10,650)	169,350
QBI	106,182
QBI deduction (20% of permitted specified service business income)	21,236
20% of taxable income before Section 199A deduction (20% of \$181,950)	36,390
Lesser of two: QBI deduction	\$21,236

Thus, his taxable income is:

Adjusted gross income	\$194,350
Standard deduction	(12,400)
QBI deduction	(21,236)
Income	\$160,714

### INAPPLICABILITY OF W-2 WAGE OR QUALIFIED PROPERTY LIMITS

Qualifying trade or business income, other than that from specified service businesses, is subject to deduction limits based on W-2 wages, and basis of qualified property. These limits are subject to the same threshold and phaseout limits and the same partial allowances that apply to specified service business income. Therefore, these limits only apply when the taxable income is above the threshold but below the full phase-out.

### OTHER TRADE OR BUSINESS RULES

U.S. source business income other than specified service business income, is subject to the QBI deduction even for taxpayers whose incomes exceed the threshold. However, there are some special limitations that affect this deduction, which are dependent upon the relationship of the taxpayer's taxable income to the thresholds and phaseouts.

## W-2 WAGE LIMITATION

A holdover rule from the now-repealed Domestic Production Activities Deduction is a limitation based on the W-2 wages paid by the business during the taxable year. In general, a taxpayer's QBI deduction is limited to 50% of W-2 wages paid. [Code Sec. 199A(b)(2)(i)]

However, there are some exceptions to this rule. First, the limit does not apply to any taxpayer whose taxable income (before the Section 199A deduction) is less than the threshold amount. [Code Sec. 199A(b)(3)(A)] The threshold and phase-ins are the same as those discussed above under specified service business income.

Moreover, a taxpayer with substantial depreciable property may qualify for the combined W-2 wage and property limitation. W-2 wages include any payment subject to either FICA or withholding. [Code Secs. 199A(b)(4)(A), 6051(a), 3401(a)] Thus, items included on Form W-2, such as health insurance for employees, including S corporation shareholder-employees, constitute part of the W-2 base. Wages paid in Puerto Rico also qualify as part of this base. [Code Sec. 199A(f)(1)(C)(ii)]

However, guaranteed payments to partners are not reported on Form W-2, but, rather, are reported on Form 1065, Schedule K-1. These payments are not part of the W-2 base. The W-2 wages are only those applicable to a qualified trade or business. [Code Sec. 199A(b)(4)(B)] Any wages allocable to foreign source income or to investment income that does not constitute trade or business income, would not be taken into account for this limit.

Moreover, the W-2 wages must be reported on a payroll tax return. This return, if not filed timely, must be filed no later than 60 days following the due date of the return. [Code Sec. 199A(b)(4)(C)]

## LIMIT PER TRADE OR BUSINESS

This limitation applies to each separate trade or business. The grouping limitations discussed above may be important in this regard.

### Example 12



Surpersoft, Inc, an S corporation, sells and installs specialized computer software. Surpersoft has a substantial payroll. Softmagic, LLC, is owned by the shareholders of Surpersoft, in equal proportions. Softmagic owns the intellectual property rights to the software sold by Surpersoft and receives royalties from Surpersoft on every copy of software it sells. Softmagic has no employees. All of the owners have taxable income in excess of the thresholds and phaseout ranges.

Since the two entities are functionally independent, in similar business lines and have identical ownership, the owners should be able to group income from both entities together and treat them as a unified business for purposes of the Section 199A deduction. Otherwise the income from Softmagic would not qualify for the deduction since it pays no W-2 wages.

## TAXABLE INCOME EXCEEDS THRESHOLD PLUS PHASEOUT

When a person's taxable income exceeds the threshold limit of \$163,300 (\$326,600 for married filing joint return or \$163,300 for married filing a separate return) plus the phaseout range of \$50,000 (\$100,000 for married filing joint return), the W-2 wage limit applies in full.

### Example 13



Bryce and Josephine file a joint return in 2020. Their combined income items are:

Ordinary income	\$50,000
Capital gains & qualified dividends	60,000
Qualified business income	750,000
AGI	860,000
Itemized deductions	(70,000)
Taxable income before 199A deduction	\$790,000

Bryce's business reported \$350,000 net income and paid \$90,000 W-2 wages this year. Josephine's net income was \$400,000 and her business paid \$1,300,000 in W-2 wages. They compute each QBI deduction separately and then combine the two.

	<b>Bryce</b>	<b>Josephine</b>	<b>Total</b>
Net income	\$350,000	\$400,000	
20% QBI	70,000	80,000	
W-2 wages	90,000	1,300,000	
W-2 limit (50%)	45,000	650,000	
Lesser amount, 2 or 4	<b>\$45,000</b>	<b>\$80,000</b>	\$125,000
Taxable income limitation (less capital gain)	730,000	20%	146,000
Section 199A deduction			\$125,000

Their itemized deductions are \$70,000. They compute their taxable income as follows:

AGI	\$860,000
Itemized deductions	70,000
Taxable income before 199A deduction	790,000
199A deduction	125,000
Taxable income	\$665,000

## WAGE AND PROPERTY LIMITATION

As an alternative to the wage limitation, a taxpayer may claim a limit based on W-2 wages plus a percentage of basis of certain property. [Code Sec. 199A(b)(2)(ii)] The first component is 25 percent of the W-2 wage base. The second component is based on the unadjusted basis of certain *qualified property* held at the end of the year. [Code Sec. 199A(b)(6)] Qualified property has several requirements as described below:

- Only tangible and depreciable property qualifies (thus land and intangibles do not qualify); [Code Sec. 199A(b)(6)(A)]
- The property must be held and available for use at the end of the year; [Code Sec. 199A(b)(6)(A)(i)]
- The property must have been used for production of QBI during the year; [Code Sec. 199A(b)(6)(A)(ii)]
- The “depreciable period” of the property must not have ended at the close of the year; [Code Sec. 199A(b)(6)(A)(iii)]
- There are some special rules relating to the depreciable period, of property, as the term applies to Section 199A:
  - If the property’s MACRS life exceeds 10 years, the depreciable period is the last full year MACRS life;
  - For other property, the depreciable period is 10 years.

The MACRS life is determined without regard to any required or elected alternative depreciation system period. The period ends with the last year in which the holder may claim an entire year of depreciation. For nonresidential property, that year would be 39 years, since the mid-month convention applies to real estate. For nonresidential property with a 27 ½ year, it would be the 27th or 28th year of ownership, depending upon the time of year the property was originally placed in service. For qualified improvement property, subject to the half-year convention or mid-quarter convention, the depreciable period ends with the 15th year.

### Example 14



Assume the same facts in Example 13 except that Bryce’s business holds \$1,500,000 of qualified property at the end of the year and Josephine’s business owns \$1,000,000 of qualified property (unadjusted basis in both cases). They would compute the QBI deductions as:

## Example 14 (continued)



	<b>Bryce</b>	<b>Josephine</b>	<b>Total</b>
Net income	\$350,000	\$400,000	
Wages paid	90,000	1,300,000	
W-2 limit (50%)	<b>45,000</b>	<b>650,000</b>	
W-2 + property limit			
Qualified property	1,500,000	1,000,000	
2.5%	37,500	25,000	
25% W-2 wages	22,500	325,000	
W-2 + property limit	<b>60,000</b>	350,000	
Limit, > of W-2 or W-2 +			
qualified property	60,000	650,000	
20% QBI	70,000	<b>80,000</b>	
20% of taxable income			
(less capital gain) before			
§199A, from Example 13			146,000
QBI deduction	60,000	80,000	\$140,000

Again, their itemized deductions are \$70,000. They compute their taxable income as follows:

AGI	\$860,000
Itemized deductions	70,000
Taxable income before 199A deduction	790,000
199A deduction	140,000
Taxable income	\$650,000

### PHASE-IN OF W-2 AND QUALIFIED PROPERTY LIMITS

The limits concerning W-2 wages and qualified property do not apply to taxpayers whose taxable income does not exceed the threshold amount, described in Table 1. [Code Sec. 199A(b)(3)(B)] When taxable income exceeds the threshold, but is still within the phaseout range, the limits apply proportionately. [Code Sec. 199A(b)(3)(B)(i)]

## Example 15



Assume the same facts in Example 14, except that Bryce and Josephine also incur a loss from an interest in a Mexican resort in which they materially participate. The loss is \$400,000, which reduces their ordinary income from \$50,000 to a loss of \$350,000. Since this business is not located in the U.S., it has no effect on QBI, *per se*.

Their joint taxable income, before the Section 199A deduction is:

Ordinary income	(\$350,000)
Capital gains & qualified dividends	60,000
Qualified business income	750,000
AGI	460,000
Itemized deductions	(70,000)
Taxable income before 199A deduction	390,000

Since they file a joint return, their threshold is \$326,600 and their phaseout range is \$100,000. Their income is between the threshold and the end of the phaseout range, so they may claim deductions for a portion of QBI in excess of the W-2 or W-2 and qualified property limits.

Their taxable income before the Section 199A deduction of \$390,000 exceeds their threshold amount of \$326,600 by \$63,400. This is 63.4% of the phaseout range. Accordingly, they can claim a Section 199A deduction for 36.6% (1-.634) of the amount by which the QBI exceeds the W-2 and property limits, in addition to the amount allowed by those limits. Their allowable Section 199A deduction, before considering the taxable income limitation, is:

## Example 15 (continued)



	Bryce	Josephine	Total
Net income	\$350,000	\$400,000	
Wages paid	90,000	1,300,000	
W-2 limit (50%)	<b>45,000</b>	<b>650,000</b>	
W-2 + property limit			
Qualified property	1,500,000	1,000,000	
2.5%	37,500	25,000	
25% W-2 wages	22,500	325,000	
W-2 + property limit	<b>60,000</b>	<b>350,000</b>	
Limit, > of W-2 or W-2 + QP	<b>60,000</b>	650,000	
20% QBI	70,000	<b>80,000</b>	
Excess	10,000	0	
Excess amount/\$100,000	63.4%	63.4%	
Excess disallowed	6,340	0	
Excess allowed	3,660	0	
Section 199A deduction	\$63,660	\$80,000	\$143,140

However, in this situation, their taxable income, less capital gain, is only \$330,000. Thus, their Section 199A deduction is limited to \$66,000. Their income tax is.

Taxable income before 199A deduction	\$390,000
199A deduction	66,000
Taxable income	324,000

### EFFECT OF QUALIFIED BUSINESS LOSS

The effect of a loss from a qualified business is to offset income from other qualified businesses. If the overall QBI is still positive, it reduces the QBI from each other business proportionately. [Reg. §1.199A-1(d)(2)(iii)(A)] If the overall QBI is negative, the result is a carryforward, which offsets QBI deductions in future years. [Reg. §1.199A-1(d)(2)(iii)(B)]

## Example 16



Assume the same facts in Example 15 except that the resort was in Puerto Rico, rather than Mexico. This loss is an item of negative QBI since any business in Puerto Rico is a U.S. business for purposes of QBI. Their joint taxable income, before the Section 199A deduction is unchanged in total, but the composition is different.

Ordinary income	\$50,000
Capital gains & qualified dividends	60,000
Qualified business income	350,000
AGI	460,000
Itemized deductions	(70,000)
Taxable income before 199A deduction	\$390,000

The loss from the Puerto Rico activity reduces their Section 199A deduction.

	<b>Bryce</b>	<b>Josephine</b>	<b>Resort</b>	<b>Total</b>
Net income	\$350,000	\$400,000	(\$400,000)	
Offset proportionately	(186,667)	(213,333)	400,000	
Net after loss	163,333	186,667		
Wages paid	90,000	1,300,000	0	
W-2 limit (50%)	45,000	650,000	0	
W-2 + property limit				
Qualified property	1,500,000	1,000,000	0	
2.5%	37,500	25,000	0	
25% W-2 wages	22,500	325,000	0	
W-2 + property limit	60,000	350,000	0	
Limit, > of W-2 or W-2 + QP	60,000	650,000	0	
20% QBI	32,667	37,333		
199A deduction	32,667	37,333		\$70,000

However, the taxable income before the QBI deduction, net of capital gains and qualified dividends, is \$66,000. Their Section 199A deduction is limited to \$62,500.

Taxable income before 199A deduction	\$390,000
199A deduction	(66,000)
Taxable income	\$324,000

## OVERALL LOSS FROM QUALIFIED BUSINESS ACTIVITIES

When the overall result of the QBI rules is negative, the negative amount carries forward and offsets future QBI deductions. [Code Sec. 199A(c)(2)]

### Example 17



Assume the same facts in Example 16, except that the loss from the Puerto Rico activity was \$780,000. Their income is:

Ordinary income	\$50,000
Capital gains & qualified dividends	60,000
Qualified business income	(30,000)
AGI	\$80,000
Itemized deductions	(70,000)
Taxable income before 199A deduction	\$10,000

Their Section 199A deduction is:

	<b>Bryce</b>	<b>Josephine</b>	<b>Resort</b>	<b>Total</b>
Net income	350,000	400,000	(780,000)	
Offset proportionately	(364,000)	(416,000)	780,000	
Net after loss	(14,000)	(16,000)		(30,000)

The \$30,000 negative item is carried forward as a separate item of QBI in 2021. Their taxable income is:

Taxable income before 199A deduction	\$10,000
199A deduction	0
Taxable income	\$10,000

The qualified business loss carryforward becomes an offset to QBI deductions in the next taxable year. [Code Sec. 199A(c)(2)]

## Example 18



Assume in 2021 Bryce and Josephine had the same losses on Bryce's business and Josephine's business, and their taxable income did not allow them any relief from the W-2 and W-2 plus qualified property limits. Now assume that the Puerto Rico resort produced a breakeven in 2021. Their 199A deduction would be computed in the same manner as in Example 17, except that they would need to include their carryforward from 2020. Their computation would be:

	<b>Bryce's business, 2021</b>	<b>Josephine's business, 2021</b>	<b>Carryforward from 2020</b>	<b>Total</b>
Net income	\$350,000	\$400,000		
Offset proportionately	(14,000)	(16,000)	(30,000)	
Net after loss	336,000	384,000		
Wages paid	90,000	1,300,000		
W-2 limit (50%)	45,000	650,000		
Qualified property	1,500,000	1,000,000		
2.5%	37,500	25,000		
25% W-2 wages	22,500	325,000		
W-2 + QP limit	60,000	350,000		
Limit, > of W-2 or W-2 + QP	60,000	650,000		
20% QBI	67,200	76,800		
199A combined	60,000	76,800		136,800
20% of taxable income (less capital gain) before §199A				146,000
199A deduction				136,800

### RULES FOR S CORPORATIONS AND PARTNERSHIPS

When the entity that actually conducts the business is not an individual, there are some special rules that apply. If the entity is a C corporation, there is no Section 199A deduction. If the entity is a partnership or S corporation, the deduction is claimed by the owners. [Code Sec. 199A(f)(1)(A)(i)]

In order for the partners or shareholders to calculate their QBI deductions, the partnership or S corporation must report the appropriate income and other items to each owner. The information needed is each partner or shareholder's portion of the necessary variables: [Code Sec. 199A(f)(1)(A)(ii)]

- Qualifying income and loss items from the qualifying business;
- W-2 wages paid by the qualifying business; and
- Qualified property owned by the business at the end of the taxable year.

## PARTNERSHIPS

If the entity is a partnership, each partner receives a share of W-2 wages according to his or her share of partnership wage expense. [Code Sec. 199A(f)(1)(A)] If the partnership makes no special allocations of wage expense, this percentage will be the same as the partner's share of partnership income.

The partnership must allocate UBIA in accordance with its allocation of depreciation to the partners on the last day of the partnership's taxable year. [Reg. §1.199A-2(a)(3)(ii)] There is no allocation of UBIA to any person who has completely disposed of his or her partnership interest before the end of the partnership's taxable year.

### Example 19



The Definer Partnership has four partners, David, Ellen, Floyd and Irene. David, the general partner, has an interest in 25% of the profits other than depreciation. David has a 10% share of partnership depreciation. The other three members each have a 25% interest in partnership income, except for depreciation and 30% of the depreciation deductions. In 2020, the partnership reports the following:

Interest income	\$60,000
Rent income	250,000
W-2 wages to employees	(30,000)
Net rent before depreciation	220,000
Depreciation	(120,000)
Net rental income	100,000
Net income overall	\$160,000

The partnership owns depreciable property with an unadjusted basis of \$2,400,000 at year end. None of this property's depreciable period has expired.

The interest income is reported separately as portfolio income and does not become part of qualified business income. Each of the four partners receives \$15,000 of interest income on Schedule K-1. The rent income is a bit more complicated.

The partners will be allocated the following:

## Example 19 (continued)



	<b>Total</b>	<b>David</b>	<b>Each other partner</b>
Interest income	\$60,000	\$15,000	\$15,000
Rent income	250,000	62,500	62,500
W-2 wages to employees	30,000	7,500	7,500
Net rent before depreciation	220,000	55,000	55,000
Depreciation	120,000	12,000	36,000
Net rental income	\$100,000	\$43,000	\$19,000

Each partner determines his or her share of the income, W-2 and W-2 plus qualified property limits as follows:

	<b>David</b>	<b>Each other partner</b>
20% Net rent	\$8,600	\$3,800
50% W-2	3,750	3,750
25% W-2	1,875	1,875
2.5% QP	6,000	18,000
25% W-2 + 2.5% QP	7,875	19,875
199A deduction	\$7,875	\$3,800

## S CORPORATIONS

When the entity is an S corporation, there will be no special allocations of any line item, such as depreciation. Therefore, if there are no changes in shareholdings during a taxable year, the qualifying income, W-2 wages, and qualified property limits will all be allocated per-share per day. However, if there is a complete termination of a shareholder's interest in the corporation, a substantial disposition of stock or a substantial issuance of new stock, there may be a split year. In this case, the corporation must allocate the income and W-2 wage information to each shareholder based on the income in each part of the year.

The S corporation must allocate UBIA in proportion to the outstanding shares on the last day of the corporation's taxable year. [Reg. §1.199A-2(a)(3)(iii)] There is no allocation of UBIA to any person who has disposed of all of his or her stock before the end of the corporation's taxable year.

## Example 20



Hamlet, Inc., an S corporation, sold a building in June 2020. It purchased another in that same month, and some equipment in December. At the beginning of the year, Ken and Linda each held half of the stock of Hamlet, Inc. On May 26, 2020, Ken sold all of his stock to Mel.

Hamlet's income and deduction items, according to each portion of the year, were:

	<b>Total</b>	<b>Jan. 1 - May 26</b>	<b>May 27 - Dec. 31</b>
Income before wages and depreciation	\$817,750	\$293,500	\$524,250
Depreciation	(77,750)	(21,500)	(56,250)
Wages	(240,000)	(72,000)	(168,000)
Net ordinary income	500,000	200,000	300,000
Section 1231 Gain	185,000		185,000
Qualifying income	\$685,000	\$200,000	\$485,000

As of December 31, Hamlet has \$2,420,000 unadjusted basis of qualified property. All of it had been used for production of qualified business income and none of this property was older than its depreciable period.

Hamlet's default allocation among the three shareholders is the weighted average per share per day method. [Code Sec. 1377(a)(1)] These pro-rata allocations will be:

	<b>Linda 50%</b>	<b>Ken 20%</b>	<b>Mel 30%</b>
Net ordinary income	\$250,000	\$100,000	\$150,000
Section 1231 gain	92,500	37,000	55,500
QBI	342,500	137,000	205,500
UBIA 50% to Linda, 50% to Mel	1,210,000	0	1,210,000

Based on these allocations, each shareholder computes the appropriate Section 199A deduction, assuming that each is above the applicable taxable income threshold, and each has sufficient taxable income to support the deduction. For all of the items except UBIA, the corporation must allocate among the three shareholders on a per-share per-day formula. However, the corporation must allocate UBIA among the shareholders in proportion to the shares held on the last day of the year. In this case, Linda holds 50% and Mel holds 50%. The shareholders would each compute their Section 199A deductions as follows:

## Example 20 (continued)



	<b>Linda</b>	<b>Ken</b>	<b>Mel</b>
20% Income	68,500	27,400	41,100
50% W-2 wages	60,000	24,000	36,000
2.5% Qualified property, 50% to Linda and 50% to Mel	30,250	0	30,250
25% W-2 wages	30,000	12,000	18,000
Combined W-2 & QP	60,250	12,000	48,250
Section 199A	60,250	24,000	41,100

Using the interim closing method to allocate income between Ken and Mel produces some different results.

	<b>Linda 50%</b>	<b>Ken 50%</b>	<b>Mel 50%</b>
<b>Interim closing</b>	<b>entire year</b>	<b>1/1-5/26</b>	<b>5/27-12/31</b>
Net ordinary income	\$250,000	\$100,000	\$150,000
Section 1231 gain	92,500	0	92,500
QBI	342,500	100,000	242,500
W-2 wages	120,000	36,000	84,000
UBIA 50% to Linda, 50% to Mel	1,210,000		1,210,000

Each of the shareholders would then compute the QBI deduction.

	<b>Linda</b>	<b>Ken</b>	<b>Mel</b>
20% Income	68,500	20,000	48,500
50% W-2 wages	60,000	18,000	42,000
2.5% Qualified property, 50% to Linda and 50% to Mel	30,250		30,250
25% W-2 wages	30,000	9,000	21,000
Combined W-2 & QP	60,250	9,000	51,250
Section 199A	60,250	18,000	48,500

Since Linda did not exchange any shares during the year, her allocation using the interim closing method is the same as the pro-rata, and her Section 199A deduction is the combined W-2 wage and qualified property limit. However, Ken, who is allocated no UBIA for the year, uses the 50% of W-2 wage limit for his deduction. Mel, like Linda, has a slight advantage from the combined W-2 wage and qualified property limit.

## APPLICATION TO COOPERATIVES AND PATRONS

Code Section 199A, after amendment by the Further Consolidated Appropriations Act, 2018, provides a special deduction for agricultural and horticultural cooperatives. In general, the deduction follows the rules for the Domestic Production Activities Deduction, prior to its repeal by the TCJA. The cooperative is allowed a deduction for 9% of its qualified production activities income of the year, or taxable income, whichever is less. [Code Sec. 199A(g)(1)(A)] The deduction is limited to 50% of the W-2 wages paid in connection with domestic production activities gross receipts. [Code Sec. 199A(g)(1)(B)]

Taxable dividends from cooperatives also qualify for the deduction by the patrons. However, the patron may be required to reduce the 20% deduction. As with the former DPAD, cooperatives may pass through a portion of this Code Section 199A(g) deduction to their patrons. Whether or not the cooperative passes through this deduction, a patron must reduce the QBI deduction attributable to patronage income by the lesser of 9% of the patron's income attributable to patronage income or 50% of wages paid by the patron in connection with the business that earned the income from the cooperative. [Code Sec. 199A(b)(7)]

## EFFECT ON PARTNER OR SHAREHOLDER BASIS

The qualified business income passes through from the partnership or S corporation to the owner. Under the general basis rules, this income increases the owner's basis, thus making it available for tax-free distributions of cash, or deduction of future losses, or losses of a different character in the same year. However, the QBI deduction, computed at the owner level, does not affect basis in the partner's interest in the partnership or the shareholder's stock or debt basis.

### Example 21



James and Meaghan are the two equal and only members in JAM, LLC. In 2020, JAM reports \$200,000 of QBI, and \$18,000 of cash charitable contributions. JAM distributes \$50,000 to each member. James itemizes his deductions and Meaghan uses the standard deduction. Both are able to claim the Section 199A deduction in full.

The effects on each member's basis and taxable income are:

	<b>James</b>	<b>Meaghan</b>	<b>Total</b>
Ordinary income	\$100,000	\$100,000	\$200,000
Distribution	(50,000)	(50,000)	(100,000)
Charitable contribution	(9,000)	(9,000)	(18,000)
Effect on basis	\$41,000	\$41,000	\$82,000
		<b>James</b>	<b>Meaghan</b>
Ordinary income		\$100,000	\$100,000
Section 199A deduction		(20,000)	(20,000)
Charitable contribution		(9,000)	
Effect on taxable income		\$71,000	\$80,000

## Comment



Although the statutory language on the effect of losses on the Section 199A deduction is scant, it seems almost certain that a loss would actually need to be allowable, and not blocked by the basis at-risk or passive activity limitations to result in a negative QBI amount.

## Example 22



Evelyn is a shareholder in Evico, an S corporation. In 2019, her share of Evico's ordinary loss is \$60,000. Evico's business qualifies for the Section 199A deduction. She has no other sources of QBI in 2019. Her basis in Evico stock is \$40,000 and she has no debt basis in Evico. The amount she can potentially deduct on her 2019 income tax return is \$40,000, and she must carry \$20,000 of the loss forward to 2020. [Code Sec. 1366(d)(2)]

She must carry \$40,000 forward to offset QBI in 2020 and future years, whether or not she is ever allowed to deduct the \$20,000 loss in excess of basis. The \$20,000 loss in excess of her basis has no effects on QBI until she can claim it on a return.

However, a loss carried forward from a year that began before 2018 does not affect QBI. The loss disallowance can be from basis, amount at risk, the passive activity loss limits, or a net operating loss. [Reg. §1.199A-3(b)(1)(iv)]

## ACCURACY-RELATED PENALTIES ON UNDERPAYMENTS

Among the penalties of underpayment, or late payment of tax, is the Section 6662 penalty imposed in cases of negligence, disregard of rules, or "substantial understatement" of income tax. [Code Sec. 6662(b)] The penalty is 20 percent of the offending amount of understatement. [Code Sec. 6662(a)]

In general, a substantial understatement exists when the understatement exceeds the greater of \$5,000 or 10 percent of the correct tax for the year. [Code Sec. 6662(d)(1)(A)] However, for any taxpayer claiming the Section 199A deduction, the 10 percent threshold is reduced to 5 percent. [Code Sec. 6662(d)(1)(C)]

## Comment



The reduction of the underpayment threshold applies to any taxpayer claiming the Section 199A deduction. The understatement need not be caused by the deduction, but could be related to any overstated deduction or understated income.

## EFFECT OF QBI DEDUCTION ON OTHER TAXES

In addition to the income tax, partners and shareholders may be subject to other taxes as a result of income from the pass-through entity. The most important federal taxes, in addition to the income tax, are:

- The alternative minimum tax;
- The self-employment tax; and
- The net investment income tax.

Section 199A specifically states that the deduction is limited to “this chapter.” To understand the scope, Section 199A is contained in:

### CHAPTER 1: NORMAL TAXES AND SURTAXES [Secs. 1—1400Z-2]

Thus, it only applies to taxes imposed on noncorporate taxpayers within these sections. The most important of these are the regular income tax (Section 1) and the alternative minimum tax (Section 55). Although the alternative minimum tax requires recalculation of several items of income and deductions, there is no second calculation of the QBI deduction for purposes of the alternative minimum tax. [Code Sec. 199A(f)(2)]

The self-employment tax rules appear in Chapter 2:

### TAX ON SELF-EMPLOYMENT INCOME.

The net investment income tax rules are in Chapter 3:

### UNEARNED INCOME MEDICARE CONTRIBUTION.

Therefore, the QBI deduction cannot reduce either of these taxes.

## II. ALTERNATIVE MINIMUM TAX

Although the House version of the TCJA would have repealed the alternative minimum tax, the final version did not go this far. The Act repealed the corporate alternative minimum tax, with a provision allowing the taxpayer to claim the alternative minimum tax credit between 2018 and 2021. [Code Sec. 53(c)]

The final version of the Tax Cuts and Jobs Act of 2017 did not repeal the alternative minimum tax for individuals. However, it substantially raised the exemption and phaseout. The 2017, 2018, and 2019 exemptions and phaseouts are:

	2017	2018	2019*	2020
Exemption, married joint	\$78,750	\$109,400	\$111,700	\$113,400
Exemption, single or head of household	50,600	70,300	71,700	72,900
Exemption, married filing separate	39,375	54,700	55,850	56,700
Exemption, estate or trust	22,500	22,500	25,000	25,400
Exemption phaseout begins, married joint	150,000	1,000,000	1,020,600	1,036,800
Exemption phaseout begins, single or head of household	112,500	500,000	510,300	518,400
Exemption phaseout begins, married filing separate	75,000	500,000	510,300	518,400
Exemption phaseout begins, estate or trust	75,000	75,000	83,500	84,800

\* Rev. Proc. 2018-57, 2018-49 IRB 827 §3.12

Pass-through entities must continue to report tax preferences and adjustments to their partners and shareholders. C corporations will need to determine their tentative alternative minimum tax for purposes of the alternative minimum tax credit. Individuals, estates and trusts will still need to determine tentative alternative minimum tax, although the imposition of the alternative minimum tax will undoubtedly apply in greatly reduced numbers.

### III. REPATRIATION OF FOREIGN EARNINGS

The United States has historically taxed its citizens and domestic corporations on their worldwide incomes. To alleviate the problems of multiple taxes on one income stream, the United States has offered a foreign tax credit.

Beginning in 2018, the U.S. approach shifted toward a territorial system, whereby domestic corporations are allowed to claim a deduction for dividends received attributable to foreign source income. [Code Sec. 245A] This deduction applies only to C corporations.

As part of the transition to the territorial system, there is a deemed repatriation of deferred foreign income for certain U.S. shareholders of foreign corporations. [Code Sec. 965] Under this rule, the U.S. shareholder must include in its income its share of undistributed foreign income from corporations in which it owns at least 10 percent of the stock. In some cases, a U.S. shareholder can be a partnership or S corporation. Since partnerships and S corporations are pass-through entities, the repatriation tax applies at the partner or shareholder level. There are certain reduced tax rates, depending upon the U.S. shareholder's portion of the cash, cash equivalents and noncash assets held abroad.

### IV. CHARITABLE CONTRIBUTIONS AND FOREIGN TAXES

One of the areas where there was a divergence between partnerships and S corporations was the relationship of charitable contributions and foreign taxes to shareholder basis. Since 1983, the Code has treated charitable contributions and foreign income taxes as items that are limited by shareholder basis [Code Sec. 1366(a)(1), flush language]

## Example 23



Sharon and Barbara each own 50% of the stock in Sharbar, Inc., an S corporation. For 2017, the corporation sustained an ordinary loss of \$80,000 and made qualifying cash contributions of \$20,000. Neither shareholder received any distribution.

Sharon had basis of \$60,000 at the beginning of 2017. She claims a deduction for \$40,000 of ordinary loss and \$10,000 of charitable contributions. She must reduce her basis by \$50,000.

Barbara had no basis at the beginning of 2017. She would not be allowed any deduction for either the ordinary loss or the charitable contributions. Her basis would remain at zero.

In contrast, charitable contributions made by the partnership and foreign income taxes paid by the partnership had not been subject to the partner basis limit for deductibility. [Code Secs. 702(a)(4), 702(a)(6), 703(a)(2)(B), 703(a)(2)(C), Reg. § 1.704-1(d)(2); Ltr. Rul. 8405084]

## Example 24



If Sharbar, from Example 23 had been a partnership, Sharon's deductible amounts would have been the same. However, Barbara, who had no basis in her partnership interest, would be able to claim her \$10,000 charitable contribution. She would not have been allowed to deduct her share of ordinary loss and would have carried that amount forward. However, the charitable contribution would not reduce her basis in her partnership interest in 2017 or in any future year.

The TCJA removed this distinction. For taxable years beginning after 2017, both charitable contributions and foreign income tax of partnerships are now subject to the same limits as other losses. [Code Sec. 704(d)(3)(A)]

## Example 25



Assume the same facts in Example 24 except that in the year 2020 Barbara would not be able to deduct any of the charitable contribution. She would need to carry it forward along with the ordinary loss from the year. Her total carryforward to 2021 would be:

Ordinary loss	\$40,000
Charitable contributions	10,000
Total	\$50,000

Assume that her share of income in 2021 was \$30,000. She would be allowed to claim 60% (\$30,000/\$50,000) of each of the carryforwards on her 2021 tax return.

This rule does not apply to the excess of fair market value over the partnership's adjusted basis of capital gain property contributed to a qualifying organization. [Code Sec. 704(d)(3)(B), Conference Report to Accompany H.R. 1, December 15, 2017, p. 515] This also conforms to the treatment of S corporations and shareholders.

### Example 26



Assume the same facts in Example 25, except that the contribution had been capital gain property with a FMV of \$60,000 and adjusted basis of \$20,000. Sharon and Barbara would each be allocated \$30,000 of fair market value and \$10,000 of basis in the contributed property. In 2020, Sharon would be able to claim a \$30,000 charitable deduction and would only reduce her basis in her partnership interest by her allocated \$10,000 of partnership basis of contributed property. Barbara would not be able to claim a \$20,000 deduction in 2020 for her allocated basis in the contributed property but would be able to claim a 2020 deduction for her share of the contributed property's unrealized appreciation.

## V. TAXES PAID ON INCOME FROM PASS-THROUGH ENTITIES

Before 2018, individuals were allowed to claim itemized deductions for state, local and foreign income taxes assessed on their taxable income, including income from partnerships and S corporations. [Code Sec. 164(a)(3)] This deduction was subject to an add-back adjustment for purposes of the alternative minimum tax. [Code Sec. 56(b)(1)(A)(ii)]

At least one attempt to treat state income tax imposed on S corporation income as a trade or business, "above the line" deduction was unsuccessful. [Cutler v. Comm'r, TC Memo 2015-73] Therefore the proper treatment of state, local and foreign income tax imposed on an individual is that of an itemized deduction.

The Tax Cuts and Jobs Act of 2017 limits the deduction for all taxes allowed as itemized deductions to \$10,000 per year. [Code Sec. 164(b)(6)] The legislative history indicates that the only exception is a business tax that is treated as an above the line deduction on Schedule C, Schedule E or Schedule F. [Conference Report to Accompany H.R. 1, December 15, 2017, p. 260]

## CHAPTER 2: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	<p><b>Which of the following would be treated as qualified business income (QBI) for an S corporation shareholder-employee:</b></p> <ul style="list-style-type: none"><li>A. wage or salary income</li><li>B. dividends (other than patronage dividends from cooperatives)</li><li>C. long-term and short-term capital gains and losses</li><li>D. none of the above</li></ul>
2.	<p><b>Which of the following deduction limits are unnecessary to compute when an activity's income is derived from a specified service business:</b></p> <ul style="list-style-type: none"><li>A. those based on W-2 wages</li><li>B. those based on the basis of qualified property</li><li>C. both A and B above</li><li>D. none of the above</li></ul>
3.	<p><b>The information needed for partners or shareholders of an S corporation to calculate their QBI deductions include all of the following <u>except</u>:</b></p> <ul style="list-style-type: none"><li>A. qualifying income and loss items from the qualifying business</li><li>B. W-2 wages paid by the qualifying business</li><li>C. qualified property owned by the business at the end of the taxable year</li><li>D. qualified property owned by the business at the beginning of the taxable year</li></ul>

4.

**For taxable years after 2017, the TCJA made which of the following subject to the same limits as other losses for partnerships:**

- A. charitable contributions made by the partnership
- B. foreign income taxes paid by the partnership
- C. both A and B above
- D. none of the above

## CHAPTER 2: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	<p><b>A.</b> Incorrect. Wage or salary income received from the activity does not constitute QBI for an S corporation shareholder-employee.</p> <p><b>B.</b> Incorrect. Dividends and equivalents are not treated as QBI, even if effectively connected with a U.S. trade or business.</p> <p><b>C.</b> Incorrect. Long-term and short-term capital gains and losses are not treated as QBI.</p> <p><b>D.</b> <b>CORRECT.</b> None of the responses are items that are treated as QBI.</p>
2.	<p><b>A.</b> Incorrect. These limits only apply when the taxable income is above the threshold but below the full phase-out.</p> <p><b>B.</b> Incorrect. These limits only apply when the taxable income is above the threshold but below the full phase-out.</p> <p><b>C.</b> <b>CORRECT.</b> These limits only apply when the taxable income is above the threshold but below the full phase-out.</p> <p><b>D.</b> Incorrect. At least one of the responses is correct.</p>
3.	<p><b>A.</b> Incorrect. These income and loss items are among the necessary variables for each partner or shareholder's portion.</p> <p><b>B.</b> Incorrect. W-2 wages paid for each partner or shareholder's portion is needed.</p> <p><b>C.</b> Incorrect. Qualified property at the end of the taxable year is a variable needed.</p> <p><b>D.</b> <b>CORRECT.</b> Qualified property owned by the business at the end of the taxable year is necessary, but not at the beginning of the taxable year.</p>
4.	<p><b>A.</b> Incorrect. Due to changes made by the TCJA, charitable contributions are subject to the same limits as other losses, but this is not the best answer.</p> <p><b>B.</b> Incorrect. Due to changes made by the TCJA, foreign income taxes paid by the partnership are subject to the same limits as other losses, but this is not the best answer.</p> <p><b>C.</b> <b>CORRECT.</b> The TCJA removed the distinction between partnerships and S corporations related to charitable contributions and foreign income taxes.</p> <p><b>D.</b> Incorrect. At least one of the responses is correct.</p>

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# FINAL EXAM COPY

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The following exam will not be graded. It is attached only for your convenience while you read the course text. To access the exam to be submitted for grading, go to your account and select Take Exam.

**1. An eligible educator can deduct up to how much of qualified expenses he or she paid in 2020:**

- A. \$0
- B. \$250
- C. \$500
- D. \$1,000

**2. All of the following can be deducted in 2020 on Schedule A, line 16, except:**

- A. federal estate tax on income in respect of a decedent
- B. gambling losses up to the amount of gambling winnings
- C. unlawful discrimination claims
- D. fines and penalties

**3. A REIT must distribute what percentage of its taxable income to its owners:**

- A. 50%
- B. 75%
- C. 90%
- D. 100%

**4. What is the taxable income threshold for a taxpayer with a filing status of single for the income from specified services to constitute qualified business income for 2020:**

- A. \$50,000
- B. \$163,300
- C. \$326,600
- D. \$426,600

**5. Which of the following is correct regarding the aggregation of multiple trades or businesses:**

- A. the Code specifies rules for the aggregation of multiple trades or businesses
- B. each partner or shareholder may be allowed to aggregate activities
- C. in order to aggregate, at least half of the owners' aggregate activities must meet specific ownership and business relationship tests
- D. in order to aggregate, a person, entity, or group must own at least 33% of each trade or business

**6. Which of the following type of service business was specifically excluded from Section 199A:**

- A. health
- B. law
- C. architecture
- D. investment management

**7. Which of the following is not included in the W-2 wage base for purposes of Section 199A:**

- A. wages paid in Puerto Rico
- B. any payment subject to either FICA or withholding
- C. guaranteed payments to partners
- D. all of the above

**8. In general, a substantial understatement of income tax exists when the understatement exceeds the greater of \$5,000 or 10 percent of the correct tax for the year. If a taxpayer is claiming the Section 199A deduction, which of the following is correct regarding the 10 percent threshold:**

- A. it is reduced to 3 percent
- B. it is reduced to 5 percent
- C. it is increased to 15 percent
- D. it is increased to 20 percent

**9. Which of the following taxes can be reduced by the qualified business income (QBI) deduction:**

- A. regular income tax
- B. self-employment tax
- C. net investment income tax
- D. all of the above

**10. The TCJA limits the deduction for all taxes allowed as itemized deductions to how much per year:**

- A. \$10,000
- B. \$20,000
- C. \$25,000
- D. unlimited