Morse & Co.
Tax-Saving Tips

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IRS Issues Final Section 199A Regulations and Defines QBI

Your ownership of a pass-through trade or business can generate a Section 199A tax deduction of up to 20 percent of your qualified business income (QBI). The C corporation does not generate this deduction, but the proprietorship, partnership, S corporation, and certain trusts, estates, and rental properties do.

The tax code says QBI includes the net dollar amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer.

Sole Proprietorship QBI

The QBI for the sole proprietor begins with your net business profit as shown on your Schedule C. You then adjust that profit as follows:

- Subtract the deduction for self-employed health insurance.
- Subtract the deduction for one-half of the self-employment tax.
- Subtract qualified retirement plan deductions.
- Subtract Section 1231 net losses (ignore gains).

Example. You have $120,000 of net income on Schedule C. You deducted $10,000 for self-employed health insurance, $8,478 for one-half of your self-employment taxes, and $10,000 for a SEP-IRA contribution. Your QBI is $91,522 ($120,000 - $10,000 - $8,478 - $10,000).

Rental Property QBI

If you own rental property as an individual or through a single-member LLC for which you did not elect corporate taxation, you report your rental activity on Schedule E of your Form 1040. If you can claim the property is a trade or business, your QBI begins with the net income from your Schedule E.

Partner's QBI from the Partnership

A partner may obtain income from the partnership in two ways: (1) as a payout of profits and/or (2) as a Section 707 payment (generally referred to as a "guaranteed payment"). The profits qualify as QBI, and the partnership profits are adjusted for the same items as with the sole proprietorship. The Section 707 payments reduce the net income of the partnership. They do not count as QBI.

S Corporation Shareholder QBI

The more than 2 percent shareholder in an S corporation ends with QBI calculated in the same manner as for the

sole proprietor. For example, the S corporation treats the health insurance as wages to the shareholder which reduces the profits of the S corporation and that reduces the shareholder's QBI.

Wages paid to the shareholder-employee reduce the net income of the S corporation but do not count as QBI.

Trusts and Estates

The rules above apply to trusts and estates. The tricky part is where to apply the rules—to the trust, to the estate, or to the beneficiary?

IRS Clarifies Net Capital Gains in Final 199A Regulations

New tax code Section 199A can give you a tax deduction of up to 20 percent of your taxable income reduced by net capital gains. In new final regulations, the IRS has provided clarity on the capital gains component of the Section 199A tax deduction.

The Section 199A tax deduction applies to your trade or business income from a pass-through entity such as a proprietorship, a rental property, a trust, an estate, a partnership, or an S corporation. When taxable income is equal to or less than the threshold of $315,000 (married, filing jointly) or $157,500 (filing as single or head of household), you apply the 20 percent to the lesser of your

- taxable income reduced by net capital gains, or
- QBI.

For the Section 199A calculation, your net capital gains are

- all net capital gains taxed at a preferred tax rate, plus
- dividends that are taxed at preferred capital gains rates.

Example. You have $200,000 of taxable income, $12,000 of unrecaptured Section 1250 capital gain from the sale of a rental property, and $13,000 of long-term capital gain from the sale of that rental. For Section 199A purposes, you apply the 20 percent deduction to a taxable income ceiling of $175,000 ($200,000 - $12,000 - $13,000).

IRS Creates a New "Safe Harbor" for Section 199A Rental Properties

The Section 199A 20 percent tax deduction is a gift from lawmakers—literally. You don't earn this deduction; it's simply there for you if you qualify.

Under the trade or business rule, your rental property profits can create the deduction. And now, under an alternative rule, you can use the newly created IRS safe harbor to make your rentals qualify for the deduction.

When you meet the new safe-harbor rules, the IRS deems your rental a trade or business with net rental profits that are QBI for the Section 199A tax deduction. But you may not want to use the safe-harbor rules, because they contain some onerous provisions. Also, you may not qualify to use the safe harbor. No problem. You can simply use the second method and win your 199A tax deduction using the existing trade or business tax law rules.

Under the new Section 199A rental real estate safe harbor (and only for this Section 199A safe harbor), each of your rental real estate properties individually or as a group (if you so choose) falls into one of the following categories:

1. Residential real estate enterprise
2. Commercial real estate enterprise
3. Triple net lease real estate

Grouping rule. You (or your pass-through entity) must either

- treat each rental property as a separate enterprise, or
- treat all similar properties as a single enterprise.

Example. You have 10 rentals; eight are residential, and two are commercial. None are triple net lease. With grouping, you have two enterprises: one residential and one commercial.

With grouping of the residential and no grouping of the commercial, you have three enterprises: residential, commercial 1, and commercial 2. (Reminder: You don't have to use the safe-harbor rules for your rental properties. You can use the historical trade or business rules.)

Safe-Harbor Requirements

Solely for Section 199A purposes, the IRS will treat your rental real estate enterprise as a trade or business if you (or your pass-through entity) can satisfy the following requirements:

1. You maintain separate books and records that reflect the income and expenses of each rental real estate enterprise.
2. You perform 250 or more hours of "rental services" during the tax year.
3. You maintain contemporaneous records, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed, (ii) description of all services performed, (iii) dates on which such services were performed, and (iv) who performed the services. (Note: The contemporaneous records rule does not apply to tax years beginning before January 1, 2019—but don't let this give you false hope; you still need proof.)

Rental Services

Qualifying defined "rental services" can be done by you, your employees, your agents, and/or your independent contractors. Such services include

1. advertising to rent or lease the real estate;
2. negotiating and executing leases;
3. verifying information contained in prospective tenant applications;
4. collecting rent;
5. operating, maintaining, and repairing the property;
6. managing the real estate;
7. purchasing materials; and
8. supervising employees and independent contractors.

Rental services that do not qualify for the safe harbor include

- financial or investment management activities, such as arranging financing, procuring property, or studying and reviewing financial statements or reports on operations;
- planning, managing, or constructing long-term capital improvements; and
- hours spent traveling to and from the real estate.

Reminder. The safe-harbor rules above are solely for Section 199A purposes.

Beware. The passive-activity rules for material participation and status as a real estate professional

contain many differences from what you see for the Section 199A tax deduction.

Time log. Your number-one important record for obtaining hassle-free tax deductions on your rental real estate is an accurate and provable time log. If you are using the new Section 199A safe harbor, you now have one additional reason to track time spent.

Non-qualifying Real Estate

Triple net lease property does not qualify for the safe harbor. Remember, the safe harbor is not the only method you can use to qualify your rental real estate for the Section 199A tax deduction.

Also, you may not use the safe harbor on real estate that you use as a residence. If you have a vacation home, Section 280A makes that vacation home either a rental property or a residence.

Safe Harbor—No 1099 Issues

If you use the safe harbor, your rental is a business regardless of whether you send 1099s to service providers. In its preamble to the final Section 199A regulations, the IRS notes that the law requires a trade or business to send 1099s to certain service providers.

Final Thoughts

You may not find it easy getting to the safe harbor. But remember, once you are inside the safe harbor, you have the comfort of knowing that your rental properties are business properties for the possible 20 percent tax deduction under Section 199A. Now, because of the safe harbor, you have a choice:

- use the safe harbor, or
- use the existing tax code trade or business rules to prove that your rental is a trade or business.

And remember, once you are inside the safe harbor, the fact that you did or did not issue 1099s to your service providers is moot for purposes of the Section 199A tax deduction.

IRS Section 199A Final Regs Shed New Light on Service Businesses

Remember, new tax code Section 199A offers you a 20 percent tax deduction gift if you have

- pass-through business income (such as from a proprietorship, a partnership, or an S corporation), and
- 2018 taxable income of $315,000 or less (married, filing jointly) or $157,500 or less (filing as single or head of household).

But once your taxable income is greater than the relevant amount listed above (which Section 199A calls a "threshold"), your Section 199A tax deduction becomes more complicated. Under the rules that apply to this new Section 199A tax deduction, the tax code creates two types of businesses:

1. Business that are in favor and *can* realize the new deduction regardless of taxable income.
2. Business that are out of favor. The tax code calls the out-of-favor business a "specified service trade or business."

If you own an out-of-favor specified service trade or business, you suffer a zero Section 199A tax deduction on that business's out-of-favor income when you have 1040 taxable income greater than $415,000 (married, filing jointly) or $207,500 (filing as single or head of household).

With taxable income greater than the $315,000/$157,500 threshold and less than the $415,000/$207,500 upper limit, Section 199A reduces the tax deduction available to your out-of-favor specified service trade or business.

This brings us to the question: What if your taxable income is above the limit, but your pass-through business has one part that's out of favor and another part that's in favor? You will like what the rules have done for you if you are in this situation. The new regulations make it clear that it is possible for you to benefit from the de minimis rule.

The rule. If the trade or business has annual gross receipts of $25 million or less, it is an in-favor business if it gets less than 10 percent of its gross receipts from an out-of-favor specified service trade or business, such as (among others) law, consulting, accounting, and health care. If gross receipts are greater than $25 million, substitute 5 percent for the 10 percent.

De Minimis Example 1

Green Lawn LLC sells lawn care and landscaping equipment and also provides advice and counsel on landscape design for large office parks and residential buildings.

The landscape design services include advice on the selection and placement of trees, shrubs, and flowers and are considered under Section 199A an out-of-favor consulting business.

Green Lawn LLC separately invoices for its landscape design services and does not sell the trees, shrubs, or flowers it recommends for use in the landscape design. Green Lawn LLC maintains one set of books and records and treats the equipment sales and design services as a single trade or business.

Green Lawn LLC has gross receipts of $2 million, of which $250,000 is attributable to the landscape design services, a consulting business. Because consulting services are 10 percent or more of total gross receipts, the entirety of Green Lawn LLC's trade or business is an out-of-favor specified service trade or business.

De Minimis Example 2

Veterinarian LLC provides veterinarian services performed by licensed staff and also develops and sells its own line of organic dog food at its veterinarian clinic and online. The veterinarian services are in the out-of-favor specified service trade or business of health care.

Veterinarian LLC separately invoices for its veterinarian services and the sale of its organic dog food. It maintains separate books and records for its veterinarian clinic and its development and sale of dog food. Veterinarian LLC also has separate employees who are unaffiliated with the veterinary clinic and work only on the formulation, marketing, sales, and distribution of the organic dog food products.

Veterinarian LLC treats its veterinary practice and the dog food development and sales as separate trades or businesses for purposes of Sections 162 and 199A. It has gross receipts of $3 million. Of the gross receipts, $1 million is attributable to the out-of-favor veterinary services.

Although the gross receipts from the services in the field of health care exceed 10 percent of Veterinarian LLC's total gross receipts, the dog food business is a separate, in-favor business.

Note that Animal Care wins because it has two trades or businesses, which it proves with its financial books and its separation of its employees.

Green Lawn LLC, in the previous example, failed because it had one business only, which it also proved by the way it kept its books.

IRS Updates Defined Wages for New Section 199A Tax Deductions

Your Section 199A tax deduction will benefit from your business's W-2 wages paid to you and your employees if you

- are married and filing jointly and your taxable income is over $315,000 and less than $415,000;
- are filing as single or head of household and your taxable income is over $157,500 and less than $207,500; or
- have an *in-favor business* and your taxable income is greater than $415,000 (married, filing jointly) or $207,500 (filing as single or head of household).

If you are above the $415,000/$207,500 threshold with no wages and no property, your Section 199A tax deduction is zero regardless of your type of business.

Example 1. You have an in-favor business with $400,000 of QBI with no wages or property. Your Form 1040 shows $500,000 of taxable income. Your Section 199A tax deduction is zero.

Note. Your $500,000 in taxable income is above the threshold. Without wages or property, the deduction is zero regardless of the type of business.

Example 2. Your in-favor business has $400,000 of QBI after wages of $300,000. Your Form 1040 shows $500,000 of taxable income. Your Section 199A tax deduction is $80,000. For Section 199A purposes, W-2 wages include

- cash wages and benefits,
- elective deferrals,
- deferred compensation, and
- designated Roth contributions.

For Section 199A purposes, you must use one of the three following IRS-created methods to find your Section 199A wages:

1. **Unmodified box method.** Under this effortless method, your W-2 wages are the lesser of Box 1 or Box 5.
2. **Modified Box 1 method.** Under this more accurate method, your W-2 wages are the total of Box 1 plus amounts in Box 12 that are coded D, E, F, G, and S minus amounts in Box 1 that are not wages for federal income tax withholding purposes.
3. **Tracking wages method.** Under this most accurate method, you track the W-2 wages subject to federal income tax withholding and add the amounts in Box 12 that are coded D, E, F, G, and S.

If you operate as an S corporation, you should use the modified Box 1 method (method 2) or the tracking wages method (method 3) to ensure your S corporation includes your elected deferrals and health insurance in its W-2 wage calculation.