Final Regulations Clarify IRC Section 199A

The IRS recently published final regulations regarding Section 199A of the IRC. That section, created by the Tax Cuts and Jobs Act of 2017, offers a 20% deduction for qualified business income (QBI). This deduction may be available to non-C-corporation taxpayers such as sole proprietors, business partners, certain LLC members, S corporation shareholders, and some others reporting business income.

As explained in the March 2019 Sapient CPA Client Bulletin, taxable income affects the ability to take the QBI deduction. The annual thresholds, which are indexed for inflation, are taxable income of $321,400 on joint returns in 2019, $160,725 for married individuals filing separately, and $160,700 for single taxpayers as well as heads of household.

Below the Thresholds

If your taxable income is below those thresholds, taking the QBI deduction might be relatively simple. You would calculate your QBI and possibly deduct 20%.

Example 1: Jane and Keith Larsen, who file a joint tax return, wind up with $250,000 of taxable income in 2019. Keith has $90,000 of QBI from his sole proprietorship. Thus, this couple can take an $18,000 (20% of $90,000) QBI deduction.

The situation is different, though, if the Larsens have $90,000 of QBI from Keith but only $60,000 of taxable income, after deductions. Now their QBI deduction is the lesser of 20% of QBI or 20% of taxable income: 20% of $60,000, or $12,000, rather than $18,000.

Above the Thresholds

With taxable income above the thresholds, limitations arise. One limitation is based on a formula involving employee wages or the taxpayer's unadjusted basis in qualified property, or both; the other limitation applies to specified service trades or business, an extensive list ranging from accounting to trading securities. In any case, reducing taxable income that's over the threshold may permit a larger QBI deduction.

Contributing to a retirement plan can reduce taxable income. However, the final regulations confirm that a pre-tax deduction for retirement plan contributions is included in the calculation of QBI. Therefore, reducing taxable income also may reduce the QBI deduction. If possible, it's better to avoid this offset.

Example 2: Suppose that Jane and Keith Larsen expect their taxable income in 2019 to be around $350,000, which would put them over the $321,400 threshold for joint filers. Reducing their taxable income by contributing $30,000 to a retirement could bring them under the threshold and increase their

QBI deduction. It would be better if the retirement contribution is made by Jane, a salaried employee. Then, Keith's QBI deduction would not be decreased.

In this example, Jane may have maxed out her retirement plan contribution for the year already, so Keith would have to be the one reducing income with a retirement plan contribution. If Keith stands to lose a 20-cent QBI deduction for every $1 deferred in a retirement plan, he is only getting an 80% net benefit from his retirement plan contribution. When he withdraws money from his retirement plan in the future, Keith will owe tax at his full tax rate, with no QBI savings.

Nevertheless, Keith may be getting a double-tax saving: Contributing to his retirement plan might reduce the couple's taxable income in 2019 and also increase his QBI deduction. Your specific circumstances will determine the potential payoff from this type of planning.

Our office can go over the numbers with you to project the tax savings from such maneuvering to affect QBI. In general, the more years you'll have until required minimum distributions start after age 70½, the greater the advantage of increasing contributions to tax-deferred retirement accounts.