Contact Information

- Kristine Tidgren
- ktidgren@iastate.edu
- www.calt.iastate.edu
- @CALT_IowaState
Qualified Business Income Deduction (I.R.C. § 199A)

Applies to:
• Sole proprietorships
• Partnerships
• S corporations
• Trusts & estates
• Special rules for REITs, PTPs, and agricultural & horticultural cooperatives

Only in place for tax years 2018 through 2025.
Qualified Business Income Deduction

QBI Deduction = Lesser of:
- 20 percent of “Qualified Business Income”
- 20 percent of (taxable income minus net capital gain)

(income above thresholds subject to SSTB and W-2 Wages/Property Limitation)

**2019 Income Thresholds:**
- $160,700 single
- $321,400 MFJ

Definition of Qualified Business Income

In general, QBI is the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer.
Exclusions from QBI

- REIT Dividends / PTP Income (Special Deduction)
- Wages, Salaries, Guaranteed payments, Reasonable Compensation
- Qualified Dividends
- Interest (unless allocable to trade or business)
- Capital gains and losses
- Annuity Income (unless received in connection with trade or business)
- Income NOT effectively connected with U.S. T or B
- I.R.C. §1231 gains and losses (when treated as capital)

Qualified Business Income

- Income from Sale of Farmland – No (if treated as capital)
- Government Program Payments – Yes
- Income from Partnerships, even if passive partner? – Yes, if it’s a trade or business
- Recapture income from sale of depreciated equipment – Yes
- Self-Rental Income – Yes, but not if from C Corp.
- Other Rental Income – If activity rises to the level of a trade or business
Trade or Business

“Section 199A does not require that a taxpayer materially participate in a trade or business in order to qualify for the section 199A deduction.”

- Not based on taxpayer’s level of participation in a trade or business.
- Dependent upon whether the individual has QBI from a trade or business.
  - Ex: Passive partners entitled to QBI deduction from trade or business conducted by the partnership

Rental Income & QBI

- Final regulations did not create a bright line test to clarify “trade or business” questions with respect to rental activities
- Must be IRC § 162 trade or business.
  - There is no bright-line definition of what types of rental activities constitute trades or businesses for purposes of IRC § 162. The courts make trade or business determinations on a case-by-case basis after a highly factual inquiry.
Three Ways for Rental Income to Qualify as QBI

1. Trade or Business – Facts and Circumstances Based upon Case Law
2. Rental to a Related Party

1. Trade or Business – Legal Standard

Preamble from final regulations reviews -

- Courts have developed two definitional requirements:
  1. Profit Motive
  2. *Considerable*, regular, and continuous activity
     - Considerable v. Substantial (Material Participation) – “Considerable” *Not* in Supreme Court cases
     - Triple net leases hard to qualify.
2. “Special Rule for Renting Property to a Related Person”

§ 1.199A-1(b)(14)

- In addition, rental or licensing of tangible or intangible property (rental activity) that does not rise to the level of a section 162 trade or business is nevertheless treated as a trade or business for purposes of section 199A, if the property is rented or licensed to a trade or business conducted by the individual or an RPE which is commonly controlled under 1.199A-4(b)(1)(i) (regardless of whether the rental activity and the trade or business are otherwise eligible to be aggregated).

Commonly Controlled

The same person or group of persons, directly or by attribution under sections 267(b) or 707(b), owns 50 percent or more of each trade or business to be aggregated...
Conducted by the Individual or an RPE

- Final regulations limited to situations in which related party is an individual or a relevant pass-through entity.
- Eliminates the ability to treat rental income from related C corporation as trade or business under this rule (proposed regulations allowed)

IRC 267(b) Related Parties (Expansion)

- Members of family under § 267(c)(4):
  - Brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants (no in-laws or step-children, but includes adopted children).
  - Individual and corporation where individual owns (directly or indirectly) more than 50 percent of stock
  - Two corporations which are members of the same controlled group (267(f))
  - A grantor and a fiduciary of any trust
  - A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts
Example

• S corporation operates a farming business.
• LLC owns farmland.
• LLC rents farmland to S corp under a triple net lease.

• S corp shareholders include Bob, Charles, and Dina (each 1/3 owners)
• LLC (taxed as partnership) owned by Bob, Charles, and Deanne (each 1/3 owners)

Yes, same persons or group of persons directly or by attribution own 50 percent or more of each.

3. Trade or Business Safe Harbor - Rentals

• Rev. Proc. 2019-38
  • Provides a safe harbor under which a rental real estate enterprise will be treated as a trade or business solely for purposes of IRC § 199A.

Note: If an enterprise fails to satisfy the requirements of the safe harbor, the rental real estate enterprise may still be treated as a trade or business for purposes of § 199A if it otherwise meets the definition of trade or business in § 1.199A-1(b)(14).
• The safe harbor provides assurance for those who meet its parameters.
Trade or Business Safe Harbor - Factors

- Maintain separate books and records to reflect income and expenses for each rental “real estate enterprise” (preamble to regs states must have common bank account);
- For taxable years < January 1, 2023, perform **250 or more hours of rental services per year with respect to the rental enterprise**.
- The taxpayer maintains *contemporaneous records*, including time reports, logs, or similar documents.

Trade or Business Safe Harbor - Services

Rental services include the following:

- Advertising to rent or lease the real estate
- Negotiating and executing leases
- Verifying information contained in the prospective tenant applications
- Collection of rent
- Daily operation, maintenance, and repair of the property
- Management of the real estate
- Purchase of materials
- Supervision of employees and independent contractors

*These activities may be performed by owners or employees, agents, or independent contractors of the owners.*
Trade or Business Safe Harbor - Services

Time devoted to the following financial or investment management activities will not constitute rental activities and cannot be counted toward the 250-hour requirement:

- Arranging financing
- Procuring property
- Studying and reviewing financial statements or reports on operations
- Planning, managing, or constructing long-term capital improvements
- Hours spent traveling to and from the real estate

Other Deductions Reduce QBI

...Deductions attributable to a trade or business are taken into account for purposes of computing QBI to the extent that the requirements of section 199A and §1.199A-3 are otherwise satisfied.

The following deductions reduce QBI if gross Income from T or B used to calculate:

- Deductible portion of SE tax
- Self-employed health insurance deduction
- Contributions to qualified retirement plans
Effect of other deductions

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<tr>
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<td>140,000</td>
<td>140,000</td>
</tr>
<tr>
<td>Less ½ SE tax</td>
<td>0</td>
<td>(9,891)</td>
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<tr>
<td>Less health Ins</td>
<td>0</td>
<td>(5,000)</td>
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<tr>
<td>Net QBI</td>
<td>140,000</td>
<td>125,109</td>
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<tr>
<td>x 20%</td>
<td>x 20%</td>
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<tr>
<td>QBID</td>
<td>28,000</td>
<td>25,022</td>
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impact! $2,978

Retirement Plans - 80 Percent Deduction?

• This allocation of deductions to QBI makes a ROTH IRA or ROTH 401K or other nondeductible contributions a more attractive option.
  • Unless high income client is trying to qualify for QBI deduction, deductible contributions will reduce taxable income and QBI. And they will be 100 percent deductible upon withdrawal.
**Taxable Income Limit**

*QBID cannot exceed (Taxable income - “Net capital gains”) x 20%*

“Net capital gain” means the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year plus qualified dividends.

**Net capital gains includes LTCG and:**
- Unrecaptured 1250 gain (25%)
- Collectibles gain (28%)
- 1202 gain (Qualified small business stock – 28%)
- Qualified dividends

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**Capital Gains**

<table>
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<tr>
<th>Calculation of QBI</th>
<th>Taxable income limit for calculating the QBI deduction</th>
<th>Taxable income for determining whether it exceeds the threshold or phasein range</th>
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Capital Gains

Calculation of QBI

Taxable income limit for calculating the QBI deduction

Taxable income for determining whether it exceeds the threshold or phasein range

Capital gains OUT

Capital gains OUT

Capital gains IN

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Qualified Business Income Deduction

Simplified Computation

DRAFT AS OF July 25, 2019

DO NOT FILE
Taxpayers with Income above and below

Share of taxpayers that take the 199A

- 5% above threshold
- 95% below threshold

**2019 Thresholds:**
- $160,700 single
- $321,400 MFJ

W-2 and Capital Limit

- QBI x 20%
- Taxable Income x 20%
- *Then a 3rd limit, if above threshold:*

W-2 and Capital Limit:
- Greater of:
  - 50% of W-2 wages, or
  - 25% of W-2 wages, + 2.5% of UBIA of qualified property
W-2 And Capital Limit (MFJ)

3 different calculations, depending on income:

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<td>Phase in period:</td>
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<td>Partial wage and capital limitation</td>
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<td>321,400</td>
<td>No wage and capital limitation</td>
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New Schedules for 2019

**Schedule A** is for Specified Service Trades or Businesses

**Schedule B** is for Aggregation of Business Operations

**Schedule C** is for Loss Netting and Carryforward

**Schedule D** provides Special Rules for Patrons of Agricultural or Horticultural Cooperatives
Remember the QBI Loss

You don’t always want the rental to be a trade or business (QBI Loss)

- Safe harbor requirements don’t shield you from IRS determining it’s a T or B for QBI Loss (“I only spend 200 hours on the property”)

- 2016 Stats:
  - Total net profit on Schedule E returns was $10,196,020,000
  - Total net loss was $5,132,470,000
Consolidated Appropriations Act, 2018
Provided Fix to “Grain Glitch” (March 2018)

• Section 13305 of Public Law 115-97, 131 Stat. 2054, 2063 (TCJA) repealed IRC § 199.
Q35. I am a farmer who is a patron of a Specified Cooperative. Could I be entitled to two deductions under section 199A?

A35. Yes. A farmer can have a qualified trade or business that generates a QBI deduction and could be passed through a Section 199A(g) deduction from the Specified Cooperative of which the farmer is a patron. Regardless of whether the section 199A(g) deduction was passed through, the farmer would have to determine whether their QBI deduction is subject to the patron reduction under section 199A(d)(7). The farmer may take any Section 199A(g) deduction passed through to the extent of their taxable income determined after their QBI deduction.

199A Patron Reduction

- Patrons selling to cooperatives must calculate 20% QBI deduction, then subtract lesser of:
  - 9% of QBI attributable to qualified payments received from cooperative
  - 50 percent W-2 wages attributable to qualified payments
    - Note if they pay no wages, there is no reduction (20% QBI deduction)
    - Those who pay wages typically get only an 11% QBI deduction
199A(g) – New DPAD

• IRC § 199A(g) allows coops to take a deduction equal to 9 percent of qualified production activities income (income-expenses). This deduction, as with DPAD, is limited to 50 percent of W-2 wages paid.

199A(g)

• Cooperative can choose to pass none, some, or all of the 199A(g) deduction through to patrons (just like old 199 DPAD).
• This 199A(g) deduction for patrons is limited only by 100% of taxable income (not subtracting capital gain). Not subject to W-2 Wage/Property limitation.
• If cooperative passes through deduction (may be up to 9% of QPAI), some farmers will get greater than 20 percent 199A deduction.
• If not, some only have 11%.
QBI Rules for Patrons of Cooperatives

- C corporations, including cooperatives or patrons, are not eligible for the 199A(a) QBI deduction.
- Trusts (other than grantor trusts) can be eligible for the 199A(a) QBI deduction.
- Estates can be eligible for the 199A(a) QBI deduction.

DPAD Transition Rule

- Applies to farmers who received a qualified payment in 2018 (or later) attributable to QPAI for which 199 DPAD was applicable.
- Any QPAI attributable to a cooperative tax year beginning before 2018.
  - Ex: Sold grain in March 2018 to coop with fiscal year ending June 30, 2018.
- These farmers can take pass-through 199 DPAD (old) deduction on their 2018 return. But 199A deduction was not allowed for such payments.
### Form 1099-PATR

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<td>8. Investment credit</td>
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<td>11. Other credits and deductions</td>
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**Copy A**

For Internal Revenue Service

File with Form 1096.

For Privacy Act and Paperwork Reduction Act.

Notice, see the 2019 General Instructions for Certain Information Returns.

**Form 1099-PATR**

Cat. No. 14429

Department of the Treasury - Internal Revenue Service

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**Iowa State University**

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**Draft As Of August 1, 2019**

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**Iowa State University**
Using the 199A(g) Deduction (New DPAD)

• Patrons to whom the specified cooperative passes the §199A(g) deduction may deduct it **up to the amount of their taxable income** (in the tax year the written notice is received, which is on or before the due date of the Form 1099-PATR).

• No W-2 wages limitation.

• Taxable income for this purpose takes into account the §199A QBI deduction, but not the §199A(g) deduction.
  • Remember that the 199A QBI deduction is limited to 20 percent of the taxpayer’s taxable income minus net capital gain.

Health Care Still Difficult

• Beginning this year, no shared responsibility payment if you don’t have health insurance.
  • This does not solve premium problems, but does provide options for other types of coverage
    • Association plans
  • Watch out for advance premium tax credits on Marketplace
    • They make insurance affordable, but come with danger.
Advanced Premium Tax Credit May Come with Danger

*Keel v. Commissioner (2018)*

- Income exceeded 400% FPL because of cancellation of debt.
  - $12,000 wages, $27,210 Supplemental, $16,164 Discharge of Indebtedness
- **APTC** had to be repaid

No Discretion for Sympathetic Circumstances

*O’Connor v. Commissioner (2018)*

- Climbed above FPL because of sale of family heirlooms when husband suffered terminal cancer.
  - Court said no leeway, had to repay.
Financial Distress Compounds Issue
Questions?

Thank You!