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Tax Relief Is Not Just for U.S. Persons: The 20% Deduction for Qualified Business Income Under New Code §199A

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Introduction

The United States Congress in its infinite wisdom has cut corporate tax rates from a maximum rate of 35% to a flat rate of 21%.¹ Believing that tax relief should not be limited to corporate taxpayers, Congress enacted new Code §199A to provide a corresponding reduction in the effective tax rates of individuals engaged in the active conduct of a trade or business as sole proprietors, partnerships, and S corporations (“pass-through entities”).² Although non-resident aliens may not customarily be regarded as “taxpayers” for U.S. purposes, they most definitely are subject to U.S. taxation on income effectively connected with the conduct of a trade or business within the United States within the meaning of Code §864(c) (“ECI”). Nothing in the statute or the legislative history suggests that the term “taxpayer” used in Code §199A is limited to U.S. persons.

Relief Under §199A

At the outset, it should be observed that the relief provided by §199A may be of limited benefit to non-resident aliens or even U.S. persons residing in high tax jurisdictions such as Canada because the resident

¹ See Code §11(b), as amended by §13001(a) of the Tax Cuts and Jobs Act, Pub. L. No. 115-97 (the “2017 tax act” or “Act”). All statutory references are to the provisions of the Internal Revenue Code of 1986, as amended by the Act.

² See Act §11011.

country’s rates of tax were already higher than the U.S. income tax rate on the taxpayer’s ECI.³ However, in those circumstances in which the U.S. tax liability is the higher of the two countries’ taxes, the 20% deduction for qualified business income provided by Code §199A will reduce the U.S. tax liability for taxpayers eligible for its benefits.

What types of businesses are eligible for the 199A deduction? By its literal terms, the relief provided by Code §199A is limited to taxpayers other than corporations. However, the statute addresses S corporations and their shareholders.⁴ Historically, non-resident aliens were not eligible S corporation stockholders. However, the 2017 tax act has amended Code §1361(c)(2)(B)(v) to exempt non-resident alien beneficiaries of electing small business trusts (ESBTs) from the look-through rule contained in that provision effective January 1, 2018.⁵ Accordingly, non-resident aliens may participate as shareholders of S corporations by owning the S corporation’s stock through an ESBT.

Any type of business activity will qualify for §199A relief with one exception and one notable qualification. The “trade or business of performing services as an employee” does not qualify.⁶ Service businesses qualify for the 20% deduction, but their owners are subject to different limitations.⁷

What income is eligible for the 20% deduction? “Qualified” REIT (real estate investment trust) divi-

³ For taxpayers residing in Canada a possible alternative to reduce the Canadian tax rate may be the use of an unlimited liability company. However, consideration should be given to Code §267A as added by the Act, as well as Article IV(7) of the Convention Between Canada and the United States of America with Respect to Taxes on Income and Capital.

⁴ See Code §199A(f).

⁵ See Act §13541(a).

⁶ Code §199A(d)(1)(B).

⁷ Code §199A(d)(1)(A). See discussion in text at nn.12–14, below.

dends and “qualified” publicly traded partnership income qualify for the 20% deduction,⁸ but for most pass-through entities the most common type of income subject to relief will be the qualified business income of the pass-through entity. For any taxable year, the qualified business income is the net amount of items of income, gain, deduction, and loss to the extent such items are effectively connected with the conduct of a trade or business within the United States within the meaning of Code §864(c) (“QBI”).⁹ Expressly excluded from QBI are:

- short- and long-term capital gains and losses,
- dividends and dividend equivalents,
- interest income other than interest income properly allocable to a trade or business,
- income from commodities transactions and foreign currency gains described in Code §954(c)(1)(C) and §954(c)(1)(D),
- income from notional principal contracts taken into account under Code §954(c)(1)(F) (with certain modifications),
- annuity income, and
- items of deduction or loss properly allocable to the preceding items.

What restrictions exist on the 20% deduction of qualified business income? The 20% deduction under Code §199A is claimed by the taxpayers who own the pass-through entity. There are two filters which restrict their deduction. The first is the taxable income of the taxpayer. The second is the W-2 wage income of the pass-through entity. The second filter applies only to taxpayers caught by the first filter. The filters are applied to each pass-through entity with respect to which the §199A deduction is claimed (each qualified trade or business).

The first filter looks to the taxable income of the taxpayer. Although this issue is not addressed by either the statute or the legislative history, taxable income for this purpose would seem to be the amount shown on line 41 of the non-resident alien’s Form 1040NR. If this assumption is correct, non-resident alien taxpayers are at a significant advantage when compared with U.S. domestic taxpayers: essentially, the taxable income of a non-resident alien is based exclusively on ECI while the taxable income of a U.S. domestic taxpayer would be based on worldwide in-

come. Thus, the taxable income reported on line 41 of the Form 1040NR is likely to be less than the taxable income reported on line 43 of Form 1040 in the case of a non-resident alien and a U.S. person, respectively, both with significant income from non-U.S. sources.

The taxable income limitation may be most easily understood as comprised of three tiers.

Tier One: The first tier is represented by taxable income of up to \$157,500 in the case of most taxpayers or twice that amount, \$315,000, in the case of taxpayers who file a joint return. Taxpayers in Tier One can deduct 20% of the QBI allocable to the taxpayers.

Tier Two: The second tier applies to taxpayers whose taxable income is greater than \$157,500 but not more than \$207,500 or, for those filing a joint return, greater than \$315,000 but not more than \$415,000. In Tier Two, wages paid and capital investment of the pass-through entity become relevant and may limit the 199A deduction (the “W-2 Wage Limitation”). The W-2 Wage Limitation is comprised of two alternative measurements. The first measurement is simply 50% of the W-2 wages paid by the pass-through entity during its taxable year. The second measurement is 25% of the W-2 wages paid by the pass-through entity plus 2.5% of the unadjusted cost basis of all tangible property used in the trade or business conducted by the pass-through entity which is subject to depreciation under Code §167.¹⁰ The taxpayer is entitled to use the measurement that produces the largest number.

Taxpayers whose taxable income reaches Tier Two compare the amount which corresponds to 20% of the taxpayer’s QBI with the W-2 Wage Limitation as computed above. The excess is subject to a reduction. The amount of the reduction is determined by the amount by which the taxpayer’s taxable income exceeds the Tier One threshold of \$157,500 (\$315,000 for joint filers) compared to \$50,000 (\$100,000 joint).¹¹

Example: The taxpayer is a sole proprietor or the sole owner of an S corporation with \$1,000,000 of QBI. The taxpayer’s deduction under Code §199A is \$200,000 (the “Tier One Deduction”), unless the taxpayer’s taxable income exceeds Tier One. Assume the taxpayer’s taxable income is \$167,500 and the taxpayer does not file a joint return. Taxable income exceeds Tier One by \$10,000. Assume further that the pass-through entity paid \$300,000 of W-2 wages during the taxable year and has very little tangible depreciable property. The W-2 Wage Limitation of

⁸ Code §199A(b)(1)(B). The term “qualified REIT dividends” is defined in Code §199A(e)(3). “Qualified publicly traded partnership income” is defined in Code §199A(e)(5).

⁹ Code §199A(c)(3)(A)(i).

¹⁰ See Code §199A(b)(6).

¹¹ Code §199A(b)(3)(B)(ii).

the taxpayer is \$150,000. The amount by which the taxpayer's Tier One Deduction exceeds the W-2 Wage Limitation is \$50,000. This excess amount is subject to reduction by an amount which corresponds to the ratio of (a) the amount by which the taxable income of the taxpayer exceeds Tier One to (b) \$50,000. The ratio of \$10,000 to \$50,000 is one-fifth. Consequently, the taxpayer's 199A deduction is reduced by \$10,000 (one-fifth times \$50,000) to \$190,000.

Tier Three: The third tier applies to taxpayers whose taxable income exceeds \$207,500 (individual) or \$415,000 (joint). The §199A deduction of these taxpayers is the amount of the W-2 Wage Limitation (that is, the greater of the two measurements calculated as described above).

What if the taxpayer is engaged in a service trade or business? For taxpayers engaged in a specified service trade or business, the 199A deduction is computed in a manner similar to, but less forgiving than, that described above.

What is a specified service trade or business? The statute refers to Code §1202(e)(3)(A) to identify the service businesses which are subject to more stringent limitations on the availability of the 199A deduction. Specified service trades or businesses (SSTBs) identified by the statute are service businesses in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing or investment management, businesses trading or dealing in securities, partnership interests or commodities as defined in Code §475(e)(2), and any other "trade or business in which the principal asset of the trade or business is the reputation or skill of 1 or more of its employees."¹²

What filters on the 199A deduction apply to an SSTB? Using the tier concept described above, taxpayers in Tier One are entitled to the full §199A deduction of 20% of QBI. Taxpayers in Tier Two are subject to a reduction based on the same ratio computed described above and illustrated by the example. However, the ratio is applied to the entire amount of the Tier One Deduction, instead of just the excess of the Tier One Deduction over the W-2 Wage Limita-

¹² Code §1202(e)(3)(A). Section 199A(d)(2)(A) specifically excludes engineering and architecture from the professional services included within the scope of an SSTB. It is unclear if an engineering or architectural business whose principal asset is the reputation or skill of one or more of its employees would be included within the scope of those businesses regarded as SSTBs.

tion and loss.¹³ Taxpayers in Tier Three get no 199A deduction.¹⁴

What if the taxpayer is not the only owner of the trade or business? In the case of taxpayers who are partners or shareholders of an S corporation, the items of income, gain, deduction, and loss of the pass-through entity are apportioned based upon the partner's or shareholder's allocable share of each item of income, gain, deduction, and loss.¹⁵ Similarly, the W-2 wages of the pass-through entity which are taken into account by the partner or shareholder are the partner's or shareholder's allocable share of wage expenses of the pass-through entity. The partner's or shareholder's allocable share of the basis of the pass-through entity's tangible depreciable property corresponds to the partner's or shareholder's allocable share of depreciation.¹⁶

Planning to Maximize the 199A Deduction

Because the first filter for the §199A deduction looks to the taxable income of the taxpayer, traditional strategies utilized to reduce taxable income will benefit the taxpayer. This includes increasing deductions taken to arrive at taxable income and transfers of investment assets producing U.S.-source income.¹⁷ With regard to the W-2 Wage Limitation, hiring additional personnel or increasing the pass-through entity's investments in tangible depreciable property increase the amount of the W-2 Wage Limitation and correspondingly reduce the amount by which Tier One Deduction exceeds the W-2 Wage Limitation.

One way of increasing the W-2 Wage Limitation in the case of a partnership is to convert to an S corporation. The partnership's guaranteed payments to its partners are not W-2 wages. Conversion to an S corporation paying amounts equivalent to the guaranteed payments as W-2 wages increases the W-2 Wage Limitation, reducing the excess amount subject to reduction in Tier Two and elimination in Tier Three. As observed above, non-resident aliens can be shareholders of S corporation when the stock of the S corporation is owned through an ESBT.

¹³ See Code §199A(d)(3)(A)(ii). If the facts of the example were applied to an SSTB, the 199A deduction would be limited to \$160,000.

¹⁴ See Code §199A(d)(3)(B).

¹⁵ Code §199A(f)(1)(A)(ii).

¹⁶ Code §199A(f)(1)(A) (flush).

¹⁷ While the 2017 tax act doubles the U.S. estate and gift tax exemption available to U.S. citizens and domiciliaries, treaties rarely extend the benefit of the gift tax exemption to assets deemed present in the United States for U.S. gift tax purposes. Generally, investment assets (other than real estate) can be sold by non-resident aliens without recognition of gain for U.S. tax purposes and can be transferred without consideration under Code §2501(a)(2) without gift tax exposure.

In the case of an SSTB, to the extent that the pass-through entity is also engaged in non-service business activities, spinning off those business activities into a separate pass-through entity would enable the non-service activity to qualify for the 199A deduction even if the taxable income of the owners reaches Tier Three levels. However, even in the case of a purely service SSTB pass-through entity, consideration should be given bifurcating the SSTB into two separate entities. The entity performing the professional services described in Code §1202(e)(3)(A) would employ the owners of the SSTB. Most other employees (the non-professionals) could be employed by a separate pass-through entity (“NewCo”) which provides a receptionist, IT support, secretarial services, marketing, document management (including secure file storage), and other services in support of the SSTB and for which NewCo is compensated on an arm’s-

length basis. Because NewCo is not an SSTB, its owners will not be subject to the reduction of the 199A deduction when taxable income of the owners enters Tier Two or the complete forfeiture of the 199A deduction when their taxable income enters Tier Three. In the case of corporate entities, it may be necessary to vary the ownership of NewCo and the SSTB to avoid application of Code §1561(a). However, if NewCo were organized as a partnership Code §1561(a) would not apply.

Taxpayers intending to take advantage of the relief provided by Code §199A should be aware of its limited shelf life. The section is set to expire with respect to taxable years beginning after December 31, 2025.¹⁸

¹⁸ Code §199A(i).