Complex 199A Deduction Has Advantages for Clients

November 29, 2018

With the comment period ending in October and the Internal Revenue Service discussing the input before issuing final guidance on the Pass-Through Entities – 199A – Deduction, accounting professionals must rely on the existing proposed guidance and the provisions within the Internal Revenue Code (IRC) to help prepare clients for tax filing.

The pass-through deduction goes into effect in 2018 and, pending additional legislative action, expires Dec. 31, 2025. A pass-through entity “passes” income through the business and to the owners, who can claim it on their individual taxes. Entities such as sole proprietorships, partnerships, S corporations, and certain limited liability corporations (LLCs) may be entitled under the 199A Deduction to a deduction of up to 20 percent of their domestic qualified business income (QBI).

QBI is the net amount of income, gain, deduction, and loss with respect to the taxpayer's qualified trade or business. The QBI does not include specified investment-related income, deductions, losses, or an S corporation shareholder's reasonable compensation or guaranteed payments.

What to consider before considering the 199A Deduction

At the forefront for accounting professionals when advising clients on whether to utilize the 199A Deduction is the complexity of applying all factors to determine the correct deduction.

Consider limitations and thresholds:

- Income levels, and the different percentages and exclusions that apply
- Specified Service Trade or Business (SSTB), which are clearly defined in some instances (performing arts, athletics) but gray in other areas (consulting). The IRS guidance has a test for the degree to which a business engages in the defining activity of the company, and that could further limit the deduction.

An SSTB is not eligible for the deduction after the maximum phase-in over the threshold – in 2018, it’s $207,500 (individual) and $415,000 (married filing jointly). In general, the proposed regulations don’t allow for segregation of SSTB and non-SSTB profits nor is the revenue amount earned from an activity that is considered an SSTB *and* would classify a business as an SSTB very high.

Here’s an example: A consulting firm has politicians as clients and they consult on media strategies as they relate to advertising in print, radio, and television. They would be, on face, considered an SSTB. However, sometimes the business produces (films and edits) ads used on radio and TV and that generate additional revenue. Is the money from these radio and TV spots considered SSTB-related revenue or are the ads tangible property separate from SSTB?

To put numbers with this example, let’s say consulting firm OnPolitics, LLC, generates $2.5 million in gross revenue, of which $2.3 million is related to producing the advertisements (non-SSTB activity) and $200,000 is from consulting fees (SSTB-related). With only 8 percent ($200,000/$2.5 million) of the firm’s total revenue defined as SSTB-related, OnPolitics, LLC, avoids SSTB status.

Why? Because the proposed regulations stipulate that a business with $25 million or less in gross revenue during the tax year must keep its SSTB-related revenue to less than 10 percent of gross revenue to avoid SSTB status.

A business with greater than $25 million in revenue during the tax year will be considered SSTB if the percentage of gross revenue derived from SSTB-related activity is five (5) percent or more.

You can begin to see the complexities that go into applying the 199A Deduction.

Preparing to advise your clients

The main premise behind using the Pass-Through Entities (199A) Deduction is to provide tax relief for specified non-corporate employers.

It would require guidance from accounting professionals, who can work with clients to control what can be controlled:

- Evaluate, under the current regulations, how to maximize the tax savings
- Revisit the business structure
- Keep abreast of additional changes and final guidance

➢ Read this article for additional details on the Pass-Through Entities (199A) Deduction.