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Newsletter

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The Ins and Outs of the Section 199A Regulations

By Edward P. Rigby, CPA

In January the IRS finalized the regulations providing guidance on the Section 199A deduction for qualified business income (QBI). The final regulations retain the majority of the rules contained in the proposed regulations that were issued last August. They provide clarification on issues such as when businesses may be aggregated in determining QBI, how real estate rented to an operating business is treated and what constitutes a specified service business. In conjunction with the release of the regulations last week, the IRS also issued a revenue procedure and a proposed revenue procedure covering the determination of wages and when rental real estate qualifies as a trade or business for purposes of the Section 199A deduction.

Limitations for Taxpayers with Taxable Income Over Certain Thresholds

In general, the Section 199A deduction is 20 percent of QBI, and is a deduction in determining taxable income. The deduction is available for individual businesses conducted as a sole proprietorship or pass-through entities such as partnerships and S corporations. C corporations are not eligible for the deduction. A limitation on the deduction applies to taxpayers with taxable income above certain thresholds. For 2018, the thresholds are \$157,500 for single taxpayers and \$315,000 for married joint filers. After 2018, these amounts are indexed for inflation. The limitation is based on W-2 wages and capital investment in depreciable property.

For taxpayers above these thresholds (subject to a phase-in rule as discussed below), the 20 percent of QBI is limited to the greater of (i) 50 percent of W-2 wages or (ii) the sum of 25 percent of W-2 wages plus 2.5 percent of the unadjusted basis immediately after acquisition of "qualified property." W-2 wages include officers salaries paid by an S corporation. Wages are based on a calendar year even if the business reports on a fiscal year basis (an exception and special rule applies for short year taxpayers). The IRS provided further guidance on the determination of W-2 wages in its release of Rev. Proc. 2019-11 which provides three methods for determining W-2 wages.

Note: Taxpayers must comply with W-2 wage reporting rules to Social Security and IRS in order for the wages to be factored in to the Section 199A deduction. Further, taxpayers with taxable income below the above thresholds are not subject to the wage and capital limits. In addition, such taxpayers below the thresholds may also claim the deduction for specified service businesses such as law and accounting service businesses.

W-2 Wage Limitation

W-2 wages for purposes of the 199A deduction are generally defined as wages subject to federal income tax withholding and certain "elective deferrals," e.g., 401(k) contributions. The first method for determining W-2 wages is called the "Unmodified Method" which simply takes the lesser of Box 1 (total taxable wages) or Box 5 (Medicare wages) on the Form W-2, without modification for elective deferrals. This method is a simplified calculation, but is not the most accurate.

Method 2 is referred to as the "Modified Box 1" method. The total Box 1 amounts of all W-2s are reduced by any amounts included in Box 1 that are not subject to income tax withholding (e.g., certain "statutory employees"), and increased by elective deferrals reported in Box 12, e.g., elective deferrals for 401(k) contributions.

Method 3 is referred to as the "Tracking Wages" method, i.e., the taxpayer tracks the total wages subject to federal income tax withholding and makes appropriate adjustments for 401(k) and other elective deferrals. This method is also required for short year taxpayers.


Aggregation Rules

Aggregation rules allow taxpayers meeting certain requirements to calculate QBI and the wage and capital limitations by combining more than one trade or business. Aggregation is allowed for businesses under common control (direct or indirect ownership of each trade or business by the same person or group

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of persons) based on a 50-percent ownership threshold. Also, the businesses must satisfy at least two of the following tests:

- The businesses must provide products or services that are the same or normally offered together.
- The businesses must share facilities or significant centralized business elements such as accounting, purchasing and personnel.
- The businesses must be operated in coordination with or reliance upon one or more businesses in the aggregated group, e.g., manufacturing and supply chain integration.

The rules covering aggregation of trades or businesses also do not allow a specified service business to be aggregated with a non-specified service business. Aggregation is an elective determination and is not required. For pass-through businesses, the aggregation election is made at the partnership or S corporation level. Disclosure rules apply for tax return filing, i.e., taxpayers must disclose the businesses that are being aggregated. Year-by-year consistency is also required unless facts and circumstances change and businesses would not otherwise be eligible for aggregation.

Rental Real Estate Safe Harbor

The QBI deduction requires that the business must be treated as a trade or business under the Code Section 162 rules. Unless an activity rises to the level of being considered a trade or business, the deduction is not available. The final regulations kept the rule contained in the proposed regulations that the rental or lease of both tangible and intangible property to an operating business under common control (e.g., ownership of rental real estate that rents a facility to a manufacturing business with the same ownership) will be treated as a trade or business for purposes of the QBI deduction and may also be aggregated as long as the above aggregation rules are met.

In addition, the IRS provided a proposed revenue procedure (Notice 2019-7) that contains a safe harbor test that treats a rental real estate activity as a trade or business if three conditions are satisfied. The three conditions are met if the taxpayer maintains separate books and records for the rental activity, 250 or more hours of rental services are performed, and the taxpayer maintains records proving the hours of services, description of services, and dates (e.g., time reports, logs, or similar documents). Rental services include advertising, negotiating leases, collection of rents, and daily operations such as maintenance and repairs of the property. The mere review of financial statements as an investor is not considered a rental service for purposes of the safe harbor.

The IRS notice further states that a taxpayer may still qualify the rental activity as a trade or business even if the safe harbor tests are not met if the requirements provided in the regulations (i.e., the definition of a trade or business is subject to Code Section 162) are otherwise satisfied.

Specified Service Trade or Business

The final regulations retain most of the examples provided in the proposed regulations and also clarified the “de minimis” rule. Care must be taken to obtain a thorough understanding of the taxpayer’s facts and circumstances to ensure an accurate determination of whether or not the business is a specified service. For example, a consulting business providing advice and counsel to a client will likely be treated as a specified service. However, a business that licenses computer software is likely to be treated as a non-specified service business, thus eligible for the deduction.

Under a de minimis rule, for taxpayers with gross receipts under \$25 million, if less than 10 percent of the gross receipts are a specified service and the remaining gross receipts are non-service, the entire business will be treated as a non-specified service. In contrast, if greater than 10 percent of gross receipts are associated with a specified service, then the entire business will be treated as a specified service. The regulations provide an exception to this rule if the business would be eligible to maintain separate books and records.

Summary

The wage and capital limitations are applicable for taxpayers with taxable income above the \$157,500 threshold for single taxpayers and \$315,000 for married joint filers. In addition, taxpayers with taxable income below the respective thresholds can take the deduction even if the business is a specified service. There is a phase in range for the limitation rules if the taxable income exceeds \$157,500 but less than \$207,500 for a single taxpayer and \$315,000 but less than \$415,000 for a married joint filer. The wage limitation only applies if 20 percent of QBI is larger than the greater of (i) 50 percent of W-2 wages or (ii) 25 percent of W-2 wages plus 2.5 percent of the unadjusted basis immediately after acquisition of qualified property (i.e., depreciable property). The W-2 wages may be calculated based on the IRS’ recent revenue procedure as discussed above (the tracking wages method is the most accurate and is also required for a short taxable year). Further, the W-2 wages must be determined on a calendar year basis even if the underlying business uses a fiscal tax year other than a calendar year end and there is a reporting requirement through filing with the Social Security Administration.

Aggregation rules discussed above require common ownership and the satisfaction of at least two tests, i.e., similar products or services, sharing facilities or significant business elements such as accounting functions, and operations that rely upon one or more businesses in the aggregated group. Specified service businesses cannot be aggregated with non-service businesses. Rental real estate meeting the above rules may be aggregated with an operating business. IRS guidance issued in conjunction with the final regulations provide safe harbor rules that allow a rental real estate activity to meet the threshold of being treated as a trade or business, thus qualifying for the Section 199A deduction.

2019 Economic Forecast for NJ Developers, Builders

Real estate developers and builders are strongly affected by economic conditions. As one of the only NJ accounting firms with a practice dedicated entirely to A/E/C accounting, The Curchin Group closely follows national and regional housing trends to help developers, builders, general contractors, architects and engineers make informed financial decisions and overcome the unique challenges that businesses in the A/E/C industry face. Curchin Partner, William McNamara, offers several key insights from recent economic forecasts he has attended.

Economy Holds Strong...

Charles Dougherty, VP & Economist at Wells Fargo Securities, LLC, and Robert Dietz, Ph.D., Chief Economist at the National Association of Home Builders, each suggested separately that we will not see a recession in 2019, despite what the media may be saying. There are just too many positive indicators that the economy is strong and growing. For example, unemployment is at record lows and not expected to jump this year.

Additionally, both economists believe the Federal Reserve Board will now move interest rates only three times in 2019. Fed Chairman Jerome Powell originally said there would be four quarterly increases but has since backed away from that position. All interest rate changes should be no more than a quarter point, and two will likely only be one-eighth.

...Down Cycle Still Looms

While Dougherty and Dietz shared optimism, they also issued a reminder that economies have cyclical characteristics, and we are moving towards an exit from the current cycle as we have enjoyed economic recovery and growth. Will that be bad for a home builder?

"Yes and no," McNamara says. "The down cycle will not be anywhere as long or as devastating as the cycle we saw from 2008 to 2010, but home builders will need to manage inventory and be wary of how long product sits before it attracts interest."

McNamara added that builders will also need to have their own 'house' in order with stronger financials, lower overhead, and more diverse cash flow not reliant on new home sale closings. Builders who diversify with rental income, solar energy and technology savings now will reap the rewards of their foresight when a down cycle hits.

Low Inventory

As it stands, the NJ housing market is still impacted by low inventory in both the new home construction and resale markets. What has improved is the average cost of new homes, so while housing stats have remained lower than previous years, we are making up for it in a better average sales price per home—a particularly strong indicator here in the Jersey Shore.

Labor Shortage

Builders will continue to face shortages of skilled labor due to several factors at play, the clearest being that trade schools and vocational schools have lost attendees as prospective students focus on college and technology. Finding a way to attract those individuals has become crucial. We're seeing many builders highlight any combination of competitive pay, benefits, training, apprenticeship and mentoring programs. The message to skilled workers is that of a "no college debt" mentality.

Urban Rental Apartments Fade?

The dynamics of the apartment and rental market should be closely monitored. The common belief is that the millennial generation will eventually want to buy homes and have children, which will naturally impact high density areas and perhaps bring traditional single-family homes back into style. When and how hard that wave hits the Shore is anyone's guess; regardless, builders should expect that urban dwellers' collective idea of "home" will evolve as they age.

For more tips and takeaways to keep your A/E/C business ahead of the curve, visit www.curchin.com/construction.



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Featured Employee:



EDWARD RIGBY, CPA SENIOR TAX MANAGER

"Providing entrepreneurs and private business owners with proactive and insightful tax planning is an essential element to the success of their business."

Ed joined The Curchin Group in 2016 as senior tax manager, bringing to Curchin's tax services group a longstanding reputation as a sophisticated strategist, consultant and advisor. Ed possesses vast experience directing, motivating and managing personnel while bringing value to an esteemed clientele.

Holding a Bachelor of Science in Accounting from DeSales University and a Master of Science in Taxation from Seton Hall University, Ed has served in tax leadership roles with national accounting

firms. He also successfully founded and owned a tax consulting firm for 12 years servicing leading privately owned companies in the life sciences, manufacturing and financial services industries. Ed advises companies and business owners on complex business transactions such as corporate mergers and acquisitions, joint business ventures, and expansion into new markets, both domestic and international. Additionally, he advises companies and individuals on complex international tax matters.

A Certified Public Accountant in New Jersey, Ed is recognized as a leading corporation tax expert. He previously earned an appointed position with the American Institute of CPAs tax committee. In this role, he assisted the AICPA Tax Division in providing insight and recommendations to the U.S. Treasury Department on proposed corporation tax regulations. Ed has served as a corporation and individual tax technical advisor for the New Jersey Society of CPAs, and been invited to numerous speaking engagements presenting to businesses and industry organizations.

Firm News

CAROLYN GIUNCO KVALO PROMOTED TO MANAGING PARTNER

We are pleased to announce that Carolyn Giunco Kvalo is now Managing Partner! Carolyn joined Curchin in 1988 and became a partner in 2003. In addition to her 25-plus years of experience and deep professional expertise, she helps Curchin continue to move forward both as a company and community steward. Carolyn is the chair of our Auditing and Accounting Committee, a member of the Continuing Professional Education Committee, and leads the Curchin Cares Team for the annual American Cancer Society's Making Strides Against Breast Cancer Walk.

Let's all congratulate her on this well deserved advancement within our proud firm.