

***South Western Federal Taxation 2023 Corporations
Partnerships Estates and Trusts 46th edition Raabe
Solutions Manual***

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Instructor's Guide

Raabe/Young/Nellen/Cripe/Lassar/Persellin/Cuccia, SWFT 2023 Volume 2: Corporations, Partnerships, Estates & Trusts, 9780357719961; Chapter 2: The Deduction for Qualified Business Income for Noncorporate Taxpayers

Table of Contents

Chapter Objectives	2
Chapter Outline	2
Discussion Questions.....	16
Video Information.....	17
Related Cengage Video Content	17

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Chapter Objectives

The following objectives are addressed in this chapter:

- 2.1 Summarize the tax treatment of various forms of conducting a business.
- 2.2 Explain the rationale for the deduction for qualified business income.
- 2.3 Describe the types of taxpayers and activities that potentially generate a deduction for qualified business income.
- 2.4 Determine a taxpayer's deduction for qualified business income.
- 2.5 List and evaluate tax planning ideas for choice of entity and the deduction for qualified business income.

[\[return to top\]](#)

Chapter Outline

In the outline below, each element includes references (in parentheses) to related content. "CO CH.###" refers to the chapter objective; "PPT Slide #" refers to the slide number in the PowerPoint deck for this chapter (provided in the PowerPoints section of the Instructor Resource Center); and, as applicable for each discipline, accreditation or certification standards ("BL 1.3.3"). Introduce the chapter and use the Ice Breaker in the PPT if desired, and if one is provided for this chapter. Review learning objectives for [Chapter 2: \(PPT Slide 2\)](#).

- i. A key piece of the TCJA of 2017 was to lower the corporate income tax rate from a progressive tax rate structure (with rates from 15% to 35%) to a flat tax of 21%.
 - ii. For businesses that do not operate as regular corporations, the TCJA of 2017 created a special deduction for noncorporate taxpayers with business income.
- I. Tax Treatment of Various Business Forms (2.1, PPT Slides 6–25)
 - i. Business forms include sole proprietorships, partnerships (covered in Chapters 10 and 11 in the text), trusts and estates (covered in Chapter 20 in the text), S corporations (covered in Chapter 12 in the text), regular corporations, and limited liability companies.
 - a. Sole Proprietorships
 - i. A sole proprietorship is not a separate taxable entity. Net income or loss from the proprietorship is computed on Schedule C and reported as part of the proprietor's income on Form 1040. Thus, the proprietor pays tax on the profits of the proprietorship.
 - ii. The proprietor reports all the net profit from the business, regardless of the amount actually withdrawn during the year.

- iii. Income and expenses retain their character when reported by the proprietor.

Example: Sean Cooper operates a candy store as a sole proprietorship. He earned a profit of \$75,000 during the year and withdrew \$40,000 from the proprietorship. Sean must report the \$75,000 as net income from the proprietorship on his personal tax return.

- iv. A deduction for qualified business income (§ 199A) is available for sole proprietors. In general, this deduction is 20% of proprietorship net income and is claimed on the proprietor's Form 1040 in determining taxable income.

b. Partnerships

- i. Partnerships are tax-reporting, but not taxpaying, entities. A partnership reports its income on Form 1065.
- ii. Each partner receives a Schedule K-1 that reports the partner's share of ordinary business income (loss) along with each separately reported item allocated to the partners according to the partnership's profit and loss sharing agreement.
 - 1. Schedule K-1 items are reported on each partner's tax return. (See Example 2 in the text.)
 - 2. Individual partners can claim the deduction for qualified business income (to the extent available) on their individual tax return (Form 1040).

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c. Corporations

- i. There are two types of corporations for tax purposes: corporations governed by Subchapter C (C corporations) and corporations governed by Subchapter S (S corporations).
- ii. S corporations have the following characteristics:
 - 1. Generally, they do not pay Federal income taxes.
 - 2. Similar to partnerships in that ordinary business income (loss) flows through to the shareholders. Like partnerships, all income and expense items are not aggregated when computing ordinary business income (loss). Certain items retain their separate character.
 - 3. Income and expense items "pass through" to shareholders, who report their share of the items on their own returns. Items are allocated to shareholders according to their stock ownership interests.
- iii. Regular C corporations are subject to entity-level taxation. Other characteristics include:
 - 1. A C corporation reports its income and expenses on Form 1120.
 - 2. Dividends paid are not deductible by the corporation.

Example: A C corporation has revenues of \$80,000, has operating expenses of \$60,000, and paid dividends of \$10,000. Net income for

the year is \$20,000, since the dividends are not deductible by the corporation.

3. When a corporation distributes its income, the shareholders report dividend income on their own returns. Since the corporation pays tax on corporate income, this entity-level tax, along with the tax paid by shareholders on the distribution of that income as a dividend, results in income earned by a C corporation being subject to "double taxation."

iv. Taxation of Dividends.

1. Closely held corporation shareholders try to convert dividend distributions into tax-deductible expenses.
 - (a) One common way is to increase compensation to shareholder-employees.
 - (b) The IRS scrutinizes compensation and other economic transactions (e.g., loans, leases, and sales) between closely held corporations and their shareholders for reasonableness.
2. Dividend eligibility for the capital gains rates alleviates some of the double taxation effect. The current tax rate applicable to qualified dividend income (and long-term capital gains) is 15%, (20% for high-income taxpayers; 0% for lower-income taxpayers).

v. Comparison of Corporations and Other Forms of Doing Business. When comparing C corporations to other business forms, there are a number of factors to consider including:

- Tax rates.
 - Character of business income.
 - Business losses.
 - Employment taxes.
 - State taxes.
1. Tax Rates. A flat rate of 21% applies to corporate taxable income.
 - (a) The marginal rates for individuals range from 10% to 37%. Therefore, in many cases, the tax burden will be greater if a business is operated as a corporation. (See Example 3 in the text.)
 - (b) In other cases, when the corporate marginal tax rate is lower than the individual marginal rate, the corporate form of doing business presents tax savings opportunities.
 - (c) To explore the various tax situations, see Examples 5 and 6 in the text.
 2. Character of Business Income. With a C corporation, tax attributes of the income and expense items do not pass through to the shareholders. As a result, if the business is expected to generate tax-favored income (e.g., tax-exempt income or long-term capital gains), it may be better to choose a different business form.

3. Pass-Through of Losses. Since C corporation losses have no effect on the taxable income of the shareholders, one of the non-C corporation forms of business may be desirable if business losses are anticipated. (See Example 7 in the text.)
4. Employment Taxes. The net income of a proprietorship is subject to the self-employment tax (15.3%), as are some partnership allocations of income to partners.
 - (a) Wages paid to a shareholder-employee of a C or S corporation are subject to payroll taxes.
 - (b) A deduction is available to an individual for part of self-employment taxes paid.
5. State Taxes. At the entity level:
 - (a) State corporate income taxes and/or franchise taxes are applicable to corporations.
 - (b) Some states impose a franchise tax on all business forms (including partnerships and S corporations). If a business will be operating in multiple states, state taxes become more important.
 - (c) At the owner level, the income of sole proprietorships, S corporations, and partnerships (along with dividend distributions) is subject to state individual income taxation.
6. The tax attributes of the various forms of business entities are compared in Concept Summary 2.1 in the text.
- vi. Nontax Considerations. Nontax considerations may override tax considerations. Factors to consider include:
 - Limited liability for corporate shareholders. Unlimited liability for sole proprietors and general partners in partnerships.
 - Ability to raise large amounts of capital using the corporate form.
 - Free transferability of ownership interests in corporation.
 - Continuity of life for the corporate form of business.
 - Centralized management of a corporation. Limited partnerships may also have centralized management, which is essential for the smooth operation of a widely held business.
- d. Limited Liability Companies
 - i. A limited liability company (LLC) offers a very important nontax advantage (limited liability) plus the tax advantage of being treated as a partnership (or proprietorship, in the case of a single-member LLC) and avoiding the double taxation problem associated with C corporations.
 1. All 50 states and the District of Columbia recognize LLCs.
 2. LLC owners are called members.
 3. The tax advantage of LLCs is that qualifying businesses may be treated as proprietorships or partnerships for tax purposes, thereby

avoiding the problem of double taxation associated with regular corporations.

- ii. Entity Classification. The IRS eased the entity classification problem by issuing Check-the-box Regulations.
 1. Regulations enable taxpayers to choose the tax status of a business entity without regard to its corporate or noncorporate characteristics.
 2. Under these Regulations, an unincorporated entity with more than one owner is by default classified as a partnership.
 3. An unincorporated entity with only one owner is, by default, classified as a disregarded entity (DRE) and treated as a sole proprietorship.
 4. If an entity wants to use its default status, it simply files the appropriate tax return.
 5. Under the default rules, if no election is made, multi-owner entities are treated as partnerships and single-owner entities are sole proprietorships. New entities using a default classification should not file Form 8332 (Entity Classification Election).
 6. If the entity wants to use a status other than the default status, or if it wants to change its status, Form 8832 is used to "check the box" (Reg. §§ 301.7701-1 through -4 and -7).
 - (a) An LLC can therefore be taxed as a C corporation or S corporation.
 - (b) Since LLCs are not treated as being incorporated under state law, they default to partnership or DRE status.

II. The Challenges of Taxing Business Activities: Entity Tax Rates

- i. One goal of U.S. tax policy is to ensure the international competitiveness of U.S. corporations and attract investment in the United States from non-U.S. multinational corporations.
- a. Challenges of Lowering Tax Rates
 - i. In 1986, the United States lowered the Federal corporate income tax rate from a maximum of 46% to 34%. This led many other industrialized countries to lower their corporate tax rate.
 1. After many years, most of these countries had lowered their rate below 34%. During this time, the United States raised its top corporate rate to 35%.
 2. In response, the United States lowered its corporate tax rate to 21% in 2018. This, however, presented additional challenges.
 - ii. By lowering tax rates, the Federal government will experience reduced revenues. Another challenge is that most businesses in the United States operate in a noncorporate form (e.g., sole proprietorships, partnerships, S corporations, or LLCs).

- iii. The owners of non-C corporations are likely to have other forms of income (e.g., investment income and wages). As a result, determining how to tax the business income of pass-through entities in a manner comparable to that of a C corporation is challenging.
 - b. Lowering Tax Rates for Different Business Forms (2.2, PPT Slides 26–28)
 - i. There is more than one way to lower the tax rate on the business income noncorporate taxpayers generate from their businesses.
 - 1. An alternative rate structure could be applied to business income.
 - 2. Noncorporate taxpayers could be allowed a special deduction to reduce the income from their business activities, thereby lowering the tax base (and lowering the taxes due).
 - ii. Challenges exist in both of these approaches, as well as in determining what rate is comparable to the corporate tax rate given the double taxation of corporate income.
 - iii. Ultimately, the business deduction approach was selected.
 - 1. Code § 199A (Qualified Business Income; QBI) was added to the Internal Revenue Code. The QBI deduction allows up to a 20% deduction on the qualified business income of noncorporate taxpayers.
 - 2. As with most of the noncorporate changes made by Congress in 2017, the deduction for qualified business income is temporary; it is in effect from 2018 through 2025.
 - iv. The purpose of the deduction is to reduce the tax on business income derived outside of the C corporate form.

III. The Deduction for Qualified Business Income (2.3, PPT Slide 29)

- i. With the decision to reduce the top Federal corporate income tax rate, Congress needed to provide a means of reducing the taxes on businesses that operate in different business forms (e.g., sole proprietors, partnerships, and S corporations). Congress accomplished this with the creation of the deduction for qualified business income, which applies to noncorporate taxpayers.
 - ii. The deduction for qualified business income is 20% of qualified business income.
 - a. General Rule (2.4, PPT Slides 29–63)
 - i. At its most basic level, § 199A permits an individual to deduct 20% of the qualified business income generated through a sole proprietorship, a partnership, or an S corporation.
 - ii. In general, the deduction for qualified business income is the lesser of:
 - 1. 20% of qualified business income (QBI), or
 - 2. 20% of modified taxable income.
 - iii. There are three limitations on the QBI deduction: an overall limitation (based on modified taxable income), another that applies to high-income

taxpayers, and a third that applies to certain types of services businesses.

b. The Overall Limitation: Modified Taxable Income

- i. In all cases, the § 199A deduction may not exceed 20% of the taxpayer's modified taxable income.
- ii. Modified taxable income is taxable income before the deduction for qualified business income, reduced by any net capital gain.

c. Definition of Qualified Business Income

- i. Qualified business income is defined as the ordinary income less ordinary deductions a taxpayer earns from a "qualified trade or business" conducted in the United States by the taxpayer (e.g., from a sole proprietorship).
- ii. Qualified business income does not include certain types of investment income, such as:

- Capital gains or capital losses (including any net § 1231 gain included in capital gain and loss computations).
- Dividends.
- Interest income (unless "properly allocable" to a trade or business).
- Certain other investment items.

Nor does qualified business income include:

- The "reasonable compensation" paid to the taxpayer with respect to any qualified trade or business.
 - Guaranteed payments made to a partner for services rendered.
- iii. The § 199A Regulations indicate that a net § 1231 gain for a taxable year that is treated as a long-term capital gain is excluded from the computation of qualified business income. The Regulations also note that if the result of § 1231 netting is a loss, the ordinary loss will reduce qualified business income for that year. The Regulations are silent regarding what to do if there are multiple qualified trades or businesses and each has § 1231 gains and losses.

d. Definition of a Qualified Trade or Business

- i. For taxpayers who fall below critical taxable income thresholds established under § 199A (in 2022, \$340,100 for married taxpayers filing jointly; \$170,050 for single and head-of-household taxpayers), the scope of a qualified trade or business (QTB) is broad.
 1. In general, it includes any trade or business other than providing services as an employee.
 2. As a result, the deduction is available to sole proprietors, independent contractors, and noncorporate owners of S corporations, partnerships, and LLCs.
- ii. "Trade or Business" Under § 199A. The Supreme Court has determined that to be "engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the

taxpayer's primary purpose for engaging in the activity must be for income or profit."

1. The § 199A Regulations acknowledge that multiple businesses might be contained in a single entity, but emphasize that this determination depends on "all the facts and circumstances." At a minimum, for § 199A to apply to each business, separate books and records must be maintained for each business.
2. Rental Real Estate Safe Harbor. A rental real estate activity (or multiple rentals if the taxpayer chooses to combine them) will be treated as a trade or business for purposes of § 199A if the following conditions are met:

- Separate books and records are maintained for each rental activity (or the combined enterprise if grouped together).
- At least 250 hours of "rental services" are performed per year for the activity (or combined enterprise). This work may be performed by the owner or by employees, agents, or contractors of the owner.
- The taxpayer maintains contemporaneous records, including time reports or similar documents, supporting the services performed.

A statement is attached to the timely filed return that indicates the taxpayer is using the safe harbor, describing the properties, and acknowledging that the requirements for the safe harbor are met.

A taxpayer cannot use the safe harbor for the rental of any residence that the taxpayer uses as a personal residence for more than 14 days during the year, and the taxpayer must own the rental property directly.

- iii. Taxpayers with Multiple Businesses. The deduction for qualified business income must be determined separately for each qualified trade or business and then aggregated. This combined amount is then compared to the overall modified taxable income limit.
- e. Limitations on the QBI Deduction
 - i. Once the taxable income thresholds—\$340,100 for married taxpayers filing jointly and \$170,050 for single and head-of-household taxpayers in 2022 (\$329,800 and \$164,900 in 2021)—are reached, § 199A imposes two independent limitations.
 1. The QBI deduction is capped based on the percentage of the W-2 wages paid by the business or based on a smaller percentage of W-2 wages paid by the business and a percentage of the cost of its depreciable property used to produce QBI.
 2. The QBI deduction generally is not available for income earned from "specified service" businesses. "Specified service" businesses include

- doctors, dentists, lawyers, accountants, consultants, investment advisers, entertainers, and athletes (among others), but not engineers and architects.
- ii. In all cases, the QBI deduction can never exceed 20% of the taxpayer's modified taxable income (taxable income before the QBI deduction reduced by any net capital gain, including qualified dividend income).
- iii. Concept Summary 2.2 in the text provides a flowchart to assist in applying these rules.
- f. Limitation Based on Wages and Capital Investment
 - i. The W-2 Wages/Capital Investment Limit limits the 20% QBI deduction to the greater of:
 - 1. 50% of the "W-2 wages" paid by the QTB, or
 - 2. 25% of the "W-2 wages" paid by the QTB plus 2.5% of the taxpayer's share of the unadjusted basis immediately after acquisition of all tangible depreciable property (including real estate) used in the QTB that has not been fully depreciated prior to the close of the taxable year.
 - ii. W-2 Wages Limit. For labor-intensive businesses, 50% of the W-2 wages paid by the business will likely be the relevant limit on the QBI deduction. (See Examples 13 and 14 in the text.)
 - iii. W-2 Wages/Capital Investment Limit.
 - 1. For capital-intensive businesses (e.g., real estate), an alternate limit exists. It begins with 25% of W-2 wages paid by the QTB and adds to this amount 2.5% of the unadjusted basis (immediately after acquisition) of "qualified property."
 - 2. Qualified property includes depreciable tangible property—real or personal—that is used by the QTB during the year and whose "depreciable period" has not ended before the end of the taxable year. Land and intangible assets are not qualified property. The "depreciable period" for "qualified property" under § 199A is a minimum of 10 years. (See Example 15 in the text.)
 - 3. Many owners of pass-through businesses, especially landlords, have no employees. As a result, the 25% of W-2 wages plus 2.5% of the unadjusted basis of qualified property is most likely to affect them. (See Example 16 in the text.)
 - iv. Phase-In of W-2 Wages/Capital Investment Limit.
 - 1. The W-2 Wages/Capital Investment Limit does not apply to taxpayers with taxable income before the QBI deduction less than the threshold amount (\$340,100 for married taxpayers filing jointly; \$170,050 for singles and heads of household).
 - 2. If taxable income before the QBI deduction exceeds the threshold amount by more than \$100,000 (married filing jointly) or \$50,000 (all

- other taxpayers), the W-2 Wages/Capital Investment Limit must be used.
3. If the taxpayer's taxable income before the QBI deduction is between these two amounts and the W-2 Wages/Capital Investment portion of the QBI deduction is capping the deduction, then the general 20% QBI amount is used, but reduced as follows:
 - (a) Determine difference between the general 20% QBI deduction amount and the W-2 Wages/Capital Investment amount.
 - (b) Determine the Reduction Ratio.
 - (c) Determine the Reduction in the W-2 Wages/Capital Investment Limit.
 - (d) Determine QBI amount.
 4. See Example 17 in the text for an illustration of these calculations.
- g. Limitation for "Specified Services" Businesses
- i. For high-income taxpayers (in 2022, \$440,100 for married taxpayers filing jointly; \$220,050 for single and head-of-household taxpayers), § 199A excludes any "specified service trade or business" from the definition of a qualified trade or business.
 - ii. A specified service trade or business includes those involving:
 - The performance of services in certain fields, including health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services.
 - Services consisting of investing and investment management, trading or dealing in securities, partnership interests, or commodities.
 - Any trade or business where the business's principal asset is the reputation of one or more of its employees or owners.
 - iii. Architects and engineers are specifically excluded from this definition.
 - iv. According to the legislative history of § 199A, the taxable income thresholds where the QBI deduction is phased out for "specified service" businesses were set by Congress "to deter high-income taxpayers from attempting to convert wages or other compensation for personal services to income eligible for the 20% deduction under the provision."
 - v. Example 18 in the text illustrates that the QBI deduction phaseout for a "specified services" business is based on taxable income before the QBI deduction (not on QBI). Any income that contributes to taxable income can cause the "specified services" QBI deduction to be reduced.
 - vi. "Specified Services" Under the § 199A Regulations.
 1. The § 199A Regulations provide specific guidance for each of the "specified services" fields identified in § 199A. Exhibit 2.1 in the text provides an overview of this guidance.
 2. Examples 19 through 26 in the text illustrate these concepts.

- vii. *De Minimis* Rule. The § 199A Regulations contain a *de minimis* rule providing that a trade or business will not be considered a “specified services” business merely because it provides a small amount of services in a “specified service” activity.
 1. If a business has gross receipts of \$25 million or less and less than 10% of its receipts relates to a “specified service,” the business will not be a “specified services” business.
 2. If the business has gross receipts greater than \$25 million, then the test is less than 5% (rather than less than 10%).
 3. Whether multiple businesses exist in a single entity depends on “all the facts and circumstances.” At a minimum, separate books and records must be maintained; if they are not, and the “specified services” revenue becomes more than *de minimis*, the entire entity is tainted.
- viii. Phase-In of the “Specified Services” Limit.
 1. In computing the qualified business income with respect to a “specified services” business, the taxpayer takes into account only the “applicable percentage” of QBI and the components of the W-2 Wages/Capital Investment Limit. (See Example 30 in the text.)
 2. A second complication with “specified services” businesses with modified taxable income in the phaseout range is that—in addition to the amount of QBI, W-2 wages, and unadjusted basis of property being subject to a limitation—the W-2 Wages/Capital Investment Limitation might also apply. (See Example 31 in the text.)
 3. Compare Examples 31 and 33 in the text to demonstrate the implications (and disadvantages) of having a “specified services” business.
 4. An even more complex setting is having multiple businesses—some “specified services” and others not. (See Example 34 in the text.)
- h. Reporting the Qualified Business Income Deduction
 - i. The IRS has developed a series of forms and schedules to determine and report the QBI deduction.
 1. Form 8995 (Qualified Business Income Deduction Simplified Computation) is used when taxable income before the QBI deduction is below the limitation thresholds for the year (in 2021, \$329,800 for married taxpayers filing jointly and \$164,900 for singles and heads of household; \$340,100 and \$170,050, respectively, in 2022).
 2. Form 8995-A (Qualified Business Income Deduction) is used by taxpayers whose taxable income before the QBI deduction exceeds the limitation thresholds. This form is supplemented by a series of schedules.
 - ii. Example 35 in the text illustrates the use of Form 8995-A.

- i. Aggregation of Qualified Trades and Businesses Under the § 199A Regulations
- i. Each trade or business conducted by an individual or a “relevant pass-through entity” (e.g., a partnership or an S corporation; RPE) is a separate trade or business under § 199A. However, taxpayers may aggregate businesses if the following requirements are met:
 1. There must be control.
 2. Control is met for the “majority” of the tax year (which must include the last day of the tax year).
 3. The businesses share the same tax year.
 4. None of the businesses are “specified services” businesses.
 5. The businesses to be aggregated must satisfy two of the following three factors:
 - (a) They must provide products or services that are the same or customarily offered together.
 - (b) They must share facilities or significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources.
 - (c) The businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group.
 - ii. Aggregation can be done by either an owner or an RPE. If an RPE chooses to aggregate, the owners of the RPE are bound by that aggregation. If an RPE does not aggregate, the RPE owners need not aggregate in the same manner. As a result, one owner may choose to aggregate that business with another business while a second owner may not choose to do so.
 - iii. Aggregation is optional and generally cannot be changed once businesses are aggregated.
 - iv. Key point: The owner does not have to own more than 50% of each business directly; rather, the owner must simply establish that a group of persons owns 50% or more of all of the entities the owner wants to aggregate. (See Example 39 in the text.)
- j. Treatment of Losses
- i. If a taxpayer has a qualified business loss in one year, no QBI deduction is allowed, and the loss is carried over to the next year to reduce QBI (but not below zero).
 - ii. The statute indicates that if a taxpayer has more than one QTB and the net results of all businesses create a loss, the net loss is carried forward to the following year. (See Example 41 in the text.)
 - iii. Where a taxpayer's netting of all positive and negative QBI is positive, and at least one business produces negative QBI, an “adjusted QBI” is determined by allocating the negative QBI among all of the businesses

that produce QBI in proportion to their respective amounts of QBI. By requiring the allocation of the loss across all of the businesses that generate QBI, the § 199A Regulations prevent taxpayers from selectively allocating the loss to businesses that will have limited (or no) QBI deduction. (See Examples 42 through 44 in the text.)

k. Coordination with Other Rules

- i. The deduction for qualified business income operates along with other rules (e.g., how to determine business income).
- ii. The QBI deduction does not reduce the tax bases for self-employment taxes or the net investment income tax (NIIT).
- iii. In computing an individual's alternative minimum taxable income (AMTI), qualified business income is not changed by any of the AMT's preferences or adjustments (like depreciation) that usually apply in determining AMTI.

l. Considerations for Partnerships and S Corporations

- i. The deduction for qualified business income applies to taxpayers other than corporations. The QBI deduction is available to individuals, trusts, and estates.
- ii. Although the earlier examples involved sole proprietors, the same result would occur if the business income was instead generated by a partnership or an S corporation. (See Example 45 in the text.)
- iii. Partnerships and S corporations might use a tax year other than a calendar year. (See Example 46 in the text.)

m. Other Items in the § 199A Regulations

- i. Employee Turned Independent Contractor. An individual who was an employee of an employer and becomes an independent contractor while providing substantially the same services (either directly or indirectly through another entity) is presumed, for a three-year period, still to be an employee. This presumption may be overturned if it can be demonstrated—using common law and statutory rules—that the individual is not an employee.
- ii. Determination of “W-2 Wages.” A business can take into account any W-2 wages paid by another business provided that the W-2 wages were paid to “common law employees or officers” of that business.
 1. A business using a professional employer organization (PEO) to manage parts of its business (e.g., human resources) or to lease employees can use an allocable portion of the PEO's W-2 wages in determining its total W-2 wages.
 2. The business that actually paid and reported the W-2 wages must reduce its § 199A wages by the same amount.
- iii. Determination of Unadjusted Basis Immediately After Acquisition (UBIA). For purchased or produced property, UBIA generally will be the property's cost (under § 1012) when the property is placed in service.

1. An addition or improvement to qualified property already placed in service is treated as separate qualified property on the date the addition or improvement is placed in service.
2. For purposes of the QBI deduction, property is not qualified property if it is acquired within 60 days of the end of the tax year and disposed of within 120 days without having been used in a trade or business for at least 45 days prior to disposition, unless the taxpayer demonstrates that the principal purpose of the acquisition and disposition was a purpose other than increasing the QBI deduction.

IV. Tax Planning (2.5, PPT Slides 64–68)

- a. Corporate versus Noncorporate Forms of Business Organization
 - i. The form of business organization affects the application of various tax rules including tax rates, deductions, tax accounting methods, and tax years.
 - ii. The decision on what form to use can change as a business grows.
- b. Optimizing the Deduction for Qualified Business Income
 - i. Some planning is possible to increase the deduction or perhaps to avoid losing the deduction.
 1. For taxpayers with taxable income above the thresholds (\$340,100 if married filing jointly and \$170,050 for singles and heads of household in 2022), consider converting any contractor payments to employee wages to increase the 50% of W-2 wages limitation.
 2. For a married couple who does not reside in a community property state and has “specified services” business income above the thresholds that allow a QBI deduction, determine whether it might be better to file separate tax returns, enabling the spouse with QBI to qualify for the QBI deduction.
 3. Given the § 199A Regulations, consider how businesses can be combined or separated, including perhaps placing one or more in separate legal entities, to increase the QBI deduction.
 4. Employees might consider whether they can become self-employed in their field (which would enable the QBI deduction).

[\[return to top\]](#)

Discussion Questions

You can assign these questions several ways: in a discussion forum in your LMS; as whole-class discussions in person; or as a partner or group activity in class.

1. Discussion 1 (2.1 and 2.5, PPT Slides 6–25 and 64–68) Duration 15 minutes.
 - a. Art, an executive with Azure Corporation, plans to start a part-time business selling products on the internet. He will devote about 15 hours each week to running the business. Art's salary from Azure places him in the 35% tax bracket. He projects substantial losses from the new business in each of the first three years and expects sizable profits thereafter. Art plans to leave the profits in the business for several years, sell the business, and then retire. Would you advise Art to incorporate the business or operate it as a sole proprietorship? Why?
 - i. Answer: Art should consider operating the business as a sole proprietorship (or a single member LLC) for the first three years. If he works 15 hours per week in the business, he will exceed the minimum number of hours required to be a material participant ($52 \times 15 = 780$) under the passive activity loss rules. [An individual is treated as materially participating in an activity if he or she participates in the activity for more than 500 hours during the year. Reg. § 1.469-5T(a)(1).] Therefore, he will be able to deduct the losses against his other income, subject to the § 461(l) limitation on excess business losses. When the business becomes profitable, Art should consider incorporating. If he reinvests the profits in the business, the value of the stock should grow accordingly, and he should be able to sell his stock in the corporation for long-term capital gain.
2. Discussion 2 (2.3, 2.4, and 2.5, PPT Slides 29–68) Duration 15 minutes.
 - a. Jane and Ben are married and usually file a joint return. They live in a separate property state (rather than a community property state). Jane is a partner in a law firm and typically generates income of \$168,000. Ben is a grade school teacher with wage income of \$75,000. The couple has investment income that is less than their standard deduction. With enactment of the deduction for qualified business income, the couple is wondering if they should continue to file as married filing jointly or instead use the married filing separately status. Why do they wonder this, and what advice would you offer them and why?
 - i. Answer: If each spouse files separately, Jane's income is close to the \$170,050 married filing separately threshold relevant for a "specified services" trade or business, such as the law firm. Use of the married filing jointly filing status makes the threshold amount \$340,100, and the couple's combined income is well below this level. Thus, filing jointly will result in a full QBI deduction (not limited due to the threshold for "specified services" trade or business).

[\[return to top\]](#)

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