South Western Federal Taxation 2019 Corporations Partnerships Estates and Trusts 42nd edition Raabe Solutions Manual

SKU: 9781337702911-SOLUTIONS

SWFT 2019 Corporations, Partnerships, Estates and Trusts
Chapter 2: The Deduction for Qualified Business Income for Pass-Through Entities
End-of-Chapter Question, Exercise, and Problem Correlations

Corporations, Partnerships, Estates & Trusts 41e (2018)	Corporations, Partnerships, Estates & Trusts 42e (2019)	Corporations, Partnerships, Estates & Trusts 42e (2019) Learning Objectives	Exact Same	Revised	Brand New
Discussion Questions (DQ)					
DQ.02.01	DQ.02.01	LO1	x		
DQ.02.02	DQ.02.02	LO1		x	
DQ.02.03	DQ.02.03	LO1, 5		x	
DQ.02.06	DQ.02.04	LO1	x		
DQ.02.07	DQ.02.05	LO1	x		
	DQ.02.06	LO3			x
	DQ.02.07	LO3, 4			x
	DQ.02.08	LO3, 4			x
	DQ.02.09	LO3, 4, 5			x
	DQ.02.10	LO3, 4			x
	DQ.02.11	LO3, 4			x
	DQ.02.12	LO3, 4			x
Computational Exercises (EX)					
	EX.02.13	LO3, 4			x
	EX.02.14	LO3, 4			x
	EX.02.15	LO3, 4			x
	EX.02.16	LO3, 4			x
	EX.02.17	LO2			x
	EX.02.18	LO3, 4			x
	EX.02.19	LO3, 4			x
Problems (PR)					
PR.02.36	PR.02.20	LO1		x	
PR.02.39	PR.02.21	LO1		x	
	PR.02.22	LO3, 4			x
PR.02.40	PR.02.23	LO3, 4		x	
PR.02.41	PR.02.24	LO3, 4		x	
PR.02.42	PR.02.25	LO3, 4		x	
PR.02.43	PR.02.26	LO3, 4		x	
PR.02.44	PR.02.27	LO3, 4		x	
	PR.02.28	LO3, 4			x
	PR.02.29	LO3, 4			x
	PR.02.30	LO3, 4			x

Corporations, Partnerships, Estates & Trusts 41e (2018)	Corporations, Partnerships, Estates & Trusts 42e (2019)	Corporations, Partnerships, Estates & Trusts 42e (2019) Learning Objectives	Exact Same	Revised	Brand New
	PR.02.31	LO3, 4			x
	PR.02.32	LO3, 4			x
	PR.02.33	LO3, 4			x
	PR.02.34	LO3, 4			x
	PR.02.35	LO3, 4			x
	PR.02.36	LO3, 4			x
Cumulative (Tax Return) Problems (CP)					
N/A					
Research Problems (RP)					
RP.02.04	RP.02.01			x	
	RP.02.02				x
	RP.02.03				x
	RP.02.04				x
Becker CPA Review Questions (BCPA)					
N/A					

CHAPTER 2

THE DEDUCTION FOR QUALIFIED BUSINESS INCOME FOR PASS-THROUGH ENTITIES

SOLUTIONS TO PROBLEM MATERIALS

DISCUSSION QUESTIONS

1. (LO 1) You should ask questions that will enable you to assess both tax and nontax factors that will affect the entity choice. Some relevant questions are addressed in the following table, although there are many additional possibilities.

Question	**Reason for the Question**
What type of business are you going to operate?	This question will provide information that may affect the need for limited liability, ability to raise capital, ease of transferring interests in the business, how long the business will continue, and how the business will be managed.
What amount and type of income (loss) do you expect from the business?	Income from a business will eventually be reported on the tax returns of the owners.
What is the amount and type of income (loss) that you expect from other sources?	For example, income (loss) from a partnership, S corporation, or LLC will "flow through" to the owners. Dividends from a C corporation must be reported on the tax returns of the shareholders. Any income (loss) from other sources will also be reported on the returns of the owners. If applicable, the deduction for qualified business income must be factored into the analysis. Thus, for planning purposes, it is important to know all sources and types of income (loss) that the owners will have.
Do you expect to have losses in the early years of the business?	Losses of partnerships, S corporations, and LLCs flow through to the owners and represent potential deductions on their individual returns. The § 461(l) limitation on excess business losses must be considered in this analysis. Losses of a C corporation do not flow through.
Will you withdraw profits from the business or leave them in the business so it can grow?	Profits from a partnership, an S corporation, or an LLC will "flow through" to the owners and will be subject to taxation on their individual tax returns. Profits of a C corporation must be reported on the tax returns of the shareholders only if such profits are paid out to shareholders as dividends. Thus, in the case of a partnership, an S corporation, or an LLC, owners must pay tax on profits before reinvesting funds back into the business. In the case of a C corporation, the corporation must pay tax on its profits. The corporate 21% flat tax rate may present tax savings opportunities for high-income taxpayers, particularly where earnings are retained within the corporation.

Question	Reason for the Question
In what state(s) will the business be formed?	States assess business taxes (e.g., corporate income tax, franchise tax) on various forms of entities, including some that apply to S corporations, partnerships, and/or LLCs.

2. (LO 1) C corporations are separate taxable entities. Cassowary Corporation will report the operating income and tax-exempt income on its return (Form 1120), resulting in taxable income of $120,000 for the year. Shareholders are required to report income from a C corporation only to the extent of dividends received; thus, Barbara reports no income from Cassowary for the year. An S corporation is a tax reporting entity but (generally) not a taxable entity. Instead, its profit (loss) and separately stated items flow through to the shareholders. Emu Corporation will report ordinary business income of $120,000 and separately stated tax-exempt interest income of $8,000 on its return (Form 1120S), with 40% of these amounts allocated to Barbara (Schedule K–1). Barbara will report ordinary business income of $48,000 and tax-exempt interest income of $3,200 on her individual return (Form 1040). Barbara would claim any related deduction for qualified business income on her Form 1040. The absence of dividend distributions from Emu Corporation does not affect Barbara's treatment of the income.

3. (LO 1, 5) 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.

4. (LO 1) Yes, most states allow for single-member LLCs. Under the default rules of the check-the-box Regulations, a single-member LLC is taxed as a sole proprietor. A single-member LLC can elect to be taxed instead as a corporation by filing Form 8832 (Entity Classification Election).

5. (LO 1) The statement is correct. Because no Form 8832 was filed, the LLC will be taxed as a partnership, the default classification for multi-member LLCs under the check-the-box Regulations. A Form 8832 is required to be filed only if the taxpayer wants to elect to have the entity classified as a corporation for Federal tax purposes.

6. (LO 2) The TCJA of 2017 included a deduction for qualified business income to provide a tax cut to businesses operating outside of the corporate form.

7. (LO 3, 4) The QBI deduction is available to any noncorporate taxpayer.

8. (LO 3, 4) In general, the deduction for qualified business income is the lesser of:

   1. 20% of qualified business income, or
   2. 20% of modified taxable income.

   Effectively, the QBI deduction—a *from* AGI deduction—is the last deduction taken in determining taxable income. Further, the deduction is available whether a taxpayer uses the standard deduction or itemizes deductions.

9. (LO 3, 4)
   a. Modified taxable income is taxable income *before* the deduction for qualified business income, reduced by any net capital gain (including any qualified dividend income).

   b. Qualified business income (QBI) is defined as the ordinary income less ordinary deductions a taxpayer earns from a "qualified trade or business" (e.g., from a sole proprietorship, an S corporation, or a partnership) conducted in the United States by the taxpayer. It also includes the distributive share of these amounts from each partnership or S corporation interest held by the taxpayer. Qualified business income does not include certain types of investment income, nor does it include the "reasonable compensation" paid to the taxpayer with respect to any qualified trade or business or guaranteed payments made to a partner for services rendered.

   c. A qualified trade or business includes any trade or business other than a trade or business of providing services as an employee. However, a "specified services" trade or business is *not* a qualified trade or business.

   d. A "specified services" 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; and

      - Any trade or business where the business's principal asset is the reputation of one or more of its employees or owners.

10. (LO 3, 4, 5) If each spouse files separately, Jane's income is close to the $157,500 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 $315,000, 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).

11. (LO 3)
    a. Yes. Drivers are independent contractors rather than employees.

    b. Yes. The individual owner of the S corporation is eligible. The veterinary services are in the field of health, so this is a "specified services" trade or business. If this individual's taxable income exceeds the thresholds for his/her filing status, no QBI deduction is allowed. Guidance is needed on whether the veterinarian may separate the business activities (separating the health services from the sale of goods and boarding).

    c. Yes. A sole proprietor is eligible for a QBI deduction.

    d. Yes. The CPA's taxable income level results in a reduction.

    e. Yes. A real estate salesperson is not an employee (§ 3508). Guidance is needed on whether this activity is considered brokerage services and thus a "specified services" trade or business.

    f. Yes. If the pet sitter/dog walker is self-employed rather than an employee.

    g. Yes. A software developer operating his/her own business is eligible.

    h. No. Income earned as an employee is not eligible for a QBI deduction. Yes, the rental income is likely a trade or business and can produce a QBI deduction.

12. (LO 2, 4) Possible reasons include that the QBI deduction is somewhat similar to the § 199 deduction repealed by the TCJA of 2017. That deduction was allowed for domestic production. Also, the TCJA of 2017 moved the corporate tax system from a worldwide system toward more of a territorial system. Thus, for consistency, the § 199A deduction is for business conducted within the United States.

COMPUTATIONAL EXERCISES

13. (LO 3, 4) As Meghann's taxable income before the QBI deduction is less than the threshold amount for single taxpayers ($157,500), her QBI deduction is $15,600, computed as follows:

1.	20% of qualified business income ($110,000 × 20%), or	$22,000
2.	20% of modified taxable income ($78,000 × 20%)	$15,600

14. (LO 3, 4) Charlotte's qualified business income from CD Partners is $175,000. Her guaranteed payments do not qualify as QBI.

15. (LO 3, 4)
    a. Robert's qualified business income from ABC, Inc., is $325,000 (the net income reported to Robert as ordinary income).

    b. If reasonable compensation for Robert was $200,000, then $100,000 of the "dividends" would be reclassified as compensation under § 199A. This would reduce ABC's net income from $325,000 to $225,000 and Robert's qualified business income would be $225,000. Reasonable compensation is not QBI.

16. (LO 3, 4)
    a. Maria and Javier each have $175,000 of QBI ($350,000 of ordinary income split equally between the equal partners). The guaranteed payments Maria and Javier receive are not QBI.

    b. Now Maria and Javier each have $275,000 of QBI ($550,000 of ordinary income split equally between the equal partners). By taking smaller guaranteed payments, Maria and Javier have a larger QBI (and a larger QBI deduction). This aspect of § 199A will result in planning to determine the appropriate mix of guaranteed payments and ordinary income for flow-through entities. Lower guaranteed payments means less cash in the partner's hands (but a larger QBI deduction).

17. (LO 3, 4) Thad has a "specified services" business. As his taxable income before the QBI deduction is more than $157,500 (but less than $207,500), he will receive a partial QBI deduction. Given the W–2 wages he reports, his QBI deduction will not be limited by the W–2 Wages/Capital Investment Limit (50% of his W–2 wages is $62,500; this amount will exceed the other QBI deduction computations). Thad's QBI deduction is $12,000, computed as follows:

    (1) Determine Applicable Percentage:

$$\text{Applicable percentage} = 100\% - \frac{\$30{,}000\ (\$187{,}500 - \$157{,}500)}{\$50{,}000} = 40\%$$

    (2) Determine QBI deduction:

20% of qualified business income ($150,000 × 20%)	$30,000
× Applicable percentage	× 40%
	$12,000

18. (LO 3, 4) Jason and Paula's taxable income before the QBI deduction is $200,000. As a result, the W–2 Wages/Capital Investment Limit does *not* apply to them. Jason's QBI amount is $30,000 ($150,000 × 20%). Paula's QBI amount is ($8,000) [($40,000) × 20%]. Their combined qualified business income amount is $22,000 [$30,000 + ($8,000)]. As this amount is less than the overall limitation based on modified taxable income ($200,000 × 20% = $40,000), their QBI deduction is $22,000.

19. (LO 3, 4) $9,800. Henry's initial QBI Amount is $12,200 (20% × QBI of $61,000). He must apply the modified taxable income limitation. Assuming Henry claims the standard deduction of $12,000, his taxable income is $49,000. As this is lower than his QBI, his deduction is $9,800 (20% × $49,000).

PROBLEMS

20. (LO 1)
    a. Otter, a partnership, is not a taxpaying entity. Its profit (loss) and separate items flow through to the partners. The partnership's Form 1065 reports net profit of $110,000 ($320,000 income – $210,000 expenses). The partnership also reports the $15,000 long-term capital gain as a separately stated item on Form 1065. Ellie and Linda each receive a Schedule K–1 reflecting net profit of $55,000 and separately stated long-term capital gain of $7,500, which each reports on her own return. The 0%/15%/20% preferential tax rate applies to the LTCG. Ellie and Linda would each claim a deduction for qualified business income on their Form 1040. The withdrawals do not affect taxable income but decrease their basis in the partnership (but not below zero).

    b. Otter, an S corporation, is not a taxpaying entity. Its profit (loss) and separate items flow through to the shareholders. The S corporation's Form 1120S reports net profit of $110,000 ($320,000 income – $210,000 expenses). The S corporation also shows the $15,000 long-term capital gain as a separately stated item on Form 1120S. Ellie and Linda each receive a Schedule K–1 reporting net profit of $55,000 and separately stated long-term capital gain of $7,500, which each reports on her own return. The 0%/15%/20% preferential tax rate applies to the LTCG. Ellie and Linda would each claim a deduction for qualified business income on their Form 1040. The withdrawals do not affect taxable income but decrease their basis in the S corporation (but not below zero).

    c. Otter, a C corporation, is a taxpaying entity. Otter's Form 1120 reports taxable income of $125,000 ($320,000 income – $210,000 expenses + $15,000 LTCG). Corporations do not receive a preferential tax rate on LTCG income. Ellie and Linda report dividend income of $25,000 each. The dividend income is subject to the 0%/15%/20% preferential tax rate.

21. (LO 1) If Purple Company is a proprietorship, Kirsten must report net income of $200,000, regardless of the amount she withdraws. If the company is a C corporation, it must pay corporate tax on its taxable income and Kirsten must report any dividends she receives from the company as income.

    a. Kirsten's after-tax income is computed below:

Income from proprietorship	$200,000
Less deductions ($12,000 standard deduction + $40,000 deduction for qualified business income)	(52,000)
Taxable income	$148,000
Tax on $148,000 (see Appendix A for Tax Rate Schedules)	$ 29,810
After-tax income ($200,000 – $29,810)	$170,190

b. Kirsten's after-tax income is computed below:

Tax on corporation's net income of $200,000:	
Tax on $200,000 ($200,000 × 21%)	$ 42,000
Corporation's after-tax income ($200,000 – $42,000)	$158,000
Kirsten's taxable income ($158,000 dividend – $12,000 standard deduction)	$146,000
Kirsten's tax on $146,000 at rates applicable to dividends [($38,600 × 0%) + .15($146,000 – $38,600)]	$ 16,110
Kirsten's after-tax income ($158,000 – $16,110)	$141,890

c. The corporation will have taxable income of $42,000 ($200,000 net income before compensation deduction – $158,000 salary) and pay a tax of $8,820 ($42,000 × 21%). Kirsten will have taxable income of $146,000 ($158,000 – $12,000 standard deduction). Her tax will be $29,330, and her after-tax income will be $128,670 ($158,000 – $29,330).

22. (LO 3, 4) Shelly and her spouse have taxable income before the QBI deduction of $270,000 (this is also their modified taxable income). As their taxable income before the QBI deduction is less than the threshold amount for married taxpayers filing a joint return, the W–2 Wages/Capital Investment Limit does not apply. Their QBI deduction is $40,000, the lesser of:

1.	20% of qualified business income ($200,000 × 20%), or	$40,000
2.	20% of modified taxable income ($270,000 × 20%)	$54,000

23. (LO 3, 4) Even though this is a "specified services" business, Peter and Amy's taxable income before the QBI deduction is below the $315,000 threshold. As a result, their QBI deduction is $57,000, the *lesser of*:

1.	20% of qualified business income ($300,000 × 20%), or	$60,000
2.	20% of modified taxable income ($285,000 × 20%)	$57,000

24. (LO 3, 4) As Ashley's taxable income before the QBI deduction exceeds the $207,500 threshold, the W–2 Wages/Capital Investment Limit must be considered. Ashley's QBI deduction is $148,000, computed as follows:

1.	20% of qualified business income ($900,000 × 20%)		$180,000
2.	But no more than the *greater of*:		
	• 50% of W–2 wages ($300,000 × 50%), or		$150,000
	• 25% of W–2 wages ($300,000 × 25%) plus	$75,000	
	• 2.5% of the unadjusted basis of qualified property ($30,000 × 2.5%)	750	$ 75,750
	And *no more than*:		
3.	20% of modified taxable income ($740,000 × 20%)		$148,000

25. (LO 3, 4) As Donald's modified taxable income exceeds the $415,000 threshold, the W–2 Wages/Capital Investment Limit comes into play. Donald's QBI deduction is $250,000, computed as follows:

1.	20% of qualified business income ($1,500,000 × 20%)		$300,000
2.	But no more than the *greater of*:		
	• 50% of W–2 wages ($0 × 50%), or		$ –0–
	• 25% of W–2 wages ($0 × 25%) plus	$ –0–	
	• 2.5% of the unadjusted basis of qualified property ($10,000,000 × 2.5%)	250,000	$250,000
	And *no more than*:		
3.	20% of modified taxable income ($2,000,000 × 20%)		$400,000

26. (LO 3, 4) As Scott and Laura's taxable income before the QBI deduction exceeds $315,000, the W–2 Wages/Capital Investment Limit must be considered:

1.	20% of qualified business income ($300,000 × 20%)		$60,000
2.	But no more than the *greater of*:		
	• 50% of W–2 wages ($40,000 × 50%), or		$20,000
	• 25% of W–2 wages ($40,000 × 25%) plus	$10,000	
	• 2.5% of the unadjusted basis of qualified property ($10,000 × 2.5%)	250	$10,250
	And *no more than*:		
3.	20% of modified taxable income ($375,000 × 20%)		$75,000

As Scott and Laura's taxable income before the QBI deduction exceeds $315,000 but is less than $415,000 and *the W–2 Wages/Capital Investment Limit portion of the computation is the limiting factor*, the general 20% QBI amount is used, but reduced as follows:

(1) Determine the difference between the general 20% QBI deduction amount and the W–2 Wages/Capital Investment amount:

General 20% QBI deduction amount	$60,000
Less: The W–2 Wages/Capital Investment Limit	(20,000)
Excess	$40,000

(2) Determine the Reduction Ratio:

$$\text{Reduction ratio} = \frac{\$60{,}000\ (\$375{,}000 - \$315{,}000)}{\$100{,}000} = 60\%$$

(3) Determine the Reduction in the W–2 Wages/Capital Investment Limit:

Excess ($40,000) × Reduction ratio (60%) = $24,000

(4) Determine Final QBI Amount:

General 20% QBI deduction amount	$60,000
Less: Reduction in the W–2 Wages/Capital Investment Limit	(24,000)
Final QBI amount	$36,000

27. (LO 3, 4) Stella is not entitled to a QBI deduction in 2018. Her accounting firm is a "specified services" business, and she and her spouse's taxable income before the QBI deduction ($475,000) exceeds the $415,000 threshold for 2018.

28. (LO 3, 4) Normally, Ben and Molly would be entitled to a QBI deduction of $60,000 ($300,000 × 20%). But since their taxable income exceeds the threshold for married taxpayers ($315,000), and their QBI is from a "specified services" business (a law firm), their QBI deduction is limited to $14,400, computed as follows:

(1) Determine Applicable Percentage:

$$\text{Applicable percentage} = 100\% - \frac{\$60{,}000\ (\$375{,}000 - \$315{,}000)}{\$100{,}000} = 40\%$$

(2) Determine QBI deduction:

1.	20% of qualified business income ($300,000 × 20%)		$60,000
	× Applicable percentage		× 40%
			$24,000
2.	But no more than the *greater of*:		
	• 50% of W–2 wages ($40,000 × 50% × 40%), or		$ 8,000
	• 25% of W–2 wages ($40,000 × 25% × 40%) plus	$4,000	
	• 2.5% of the unadjusted basis of qualified property ($0 × 2.5% × 40%)	–0–	$ 4,000

As Ben and Molly's modified taxable income exceeds $315,000, but is less than $415,000 and *the W–2 Wages/Capital Investment Limit portion of the computation is the limiting factor*, the general 20% QBI amount is used, but reduced as follows:

(1) Determine the difference between the general 20% QBI deduction amount and the W–2 Wages/Capital Investment Limit amount.

General 20% QBI deduction amount	$24,000
Less: The W–2 Wages/Capital Investment Limit	(8,000)
Excess	$16,000

(2) Determine the Reduction Ratio:

$$\text{Reduction ratio} = \frac{\$60{,}000\ (\$375{,}000 - \$315{,}000)}{\$100{,}000} = 60\%$$

(3) Determine the Reduction in the W–2 Wages/Capital Investment Limit:

Excess ($16,000) × Reduction Ratio (60%) = $9,600

(4) Determine Final QBI Amount:

General 20% QBI deduction amount	$24,000
Less: Reduction in the W–2 Wages/Capital Investment limit	(9,600)
Final QBI Amount	$14,400

As the QBI amount ($14,400) is less than 20% of their modified taxable income ($75,000; $375,000 × 20%), they will be allowed a $14,400 deduction for qualified business income.

29. (LO 3, 4) Tammy's taxable income before the QBI deduction is $115,000 ($40,000 of wages plus $100,000 of proprietorship net income less $25,000 in itemized deductions). This is also her modified taxable income (she has no net capital gain or qualified dividend income). As her taxable income before the QBI deduction is less than the threshold amount for single taxpayers ($157,500), the W–2 Wages/Capital Investment Limit does not apply. Tammy's QBI deduction is $20,000, the lesser of:

1.	20% of qualified business income ($100,000 × 20%), or	$20,000
2.	20% of modified taxable income ($115,000 × 20%)	$23,000

30. (LO 3, 4) Tammy's taxable income is $75,000 ($100,000 of proprietorship net income less $25,000 in itemized deductions). This is also her modified taxable income (she has no net capital gain or qualified dividend income). As her taxable income before the QBI deduction is less than the threshold amount for single taxpayers ($157,500), the W–2 Wages/Capital Investment Limit does not apply. Tammy's QBI deduction is $15,000, the lesser of:

1.	20% of qualified business income ($100,000 × 20%), or	$20,000
2.	20% of modified taxable income ($75,000 × 20%)	$15,000

Tammy's QBI deduction is $5,000 lower in Problem 30 than it was in Problem 29, because the taxable income limitation applied. The limitation was triggered because Tammy didn't have any non-QBI income (e.g., wages from employment) to offset her individual itemized deductions (which reduced her taxable income below the amount of her qualified business income). In her situation, every additional dollar of other income (e.g., taxable interest income) will provide an additional 20 cents of QBI deduction (until her maximum QBI deduction of $20,000).

31. (LO 3, 4) Susan's taxable income before the QBI deduction is $338,000 (her proprietorship net income less the $12,000 single standard deduction); this is also her modified taxable income. As Susan's taxable income before the QBI deduction exceeds the $207,500 threshold, the W–2 Wages/Capital Investment Limit must be considered. Susan's QBI deduction is $50,000, computed as follows:

1.	20% of qualified business income ($350,000 × 20%)		$70,000
2.	But no more than the *greater of*:		
	• 50% of W–2 wages ($100,000 × 50%), or		$50,000
	• 25% of W–2 wages ($100,000 × 25%) plus	$25,000	
	• 2.5% of the unadjusted basis of qualified property ($150,000 × 2.5%)	3,750	$28,750
	And *no more than*:		
3.	20% of modified taxable income ($338,000 × 20%)		$67,600

32. (LO 3, 4) Susan's taxable income before the QBI deduction is $138,000 (her proprietorship net income less the $12,000 single standard deduction); this is also her modified taxable income. As Susan's taxable income before the QBI deduction is less than $157,500, the W–2 Wages/Capital Investment Limit does not apply. Susan's QBI deduction is $27,600, computed as follows:

1.	20% of qualified business income ($150,000 × 20%)	$30,000
	And *no more than*:	
3.	20% of modified taxable income ($138,000 × 20%)	$27,600

33. (LO 3, 4) Susan's taxable income before the QBI deduction is $202,000 (her proprietorship net income of $200,000 plus her wages of $11,000 and her $3,000 of interest income less her $12,000 standard deduction). As Susan's taxable income before the QBI deduction exceeds $157,500, the W–2 Wages/Capital Investment Limit must be considered:

1.	20% of qualified business income ($200,000 × 20%)		$40,000
2.	But no more than the *greater of*:		
•	50% of W–2 wages ($60,000 × 50%), or		$30,000
•	25% of W–2 wages ($60,000 × 25%) plus	$15,000	
•	2.5% of the unadjusted basis of qualified property ($150,000 × 2.5%)	3,750	$18,750

And *no more than*:

3.	20% of modified taxable income ($202,000 × 20%)	$40,400

So initially, Susan's QBI deduction is limited to $30,000. However, as Susan's taxable income before the QBI deduction exceeds $157,500, but is less than $207,500 and *the W–2 Wages/Capital Investment Limit portion of the computation is the limiting factor*, the general 20% QBI amount is used, but reduced as follows:

(1) Determine difference between the general 20% QBI deduction amount and the W–2 Wages/Capital Investment Limit amount.

General 20% QBI deduction amount	$40,000
Less: The W–2 Wages/Capital Investment Limit	(30,000)
Excess	$10,000

(2) Determine the Reduction Ratio:

$$\text{Reduction ratio} = \frac{\$44{,}500\ (\$202{,}000 - \$157{,}500)}{\$50{,}000} = 89\%$$

(3) Determine the Reduction in the W–2 Wages/Capital Investment Limit:

Excess ($10,000) × Reduction ratio (89%) = $ 8,900

(4) Determine Final QBI Amount:

General 20% QBI deduction amount	$40,000
Less: Reduction in the W–2 Wages/Capital Investment Limit	(8,900)
Final QBI Amount	$31,100

34. (LO 3, 4)

a. Jennifer's CPA practice is a "specified services" business. However, because her taxable income before the QBI deduction is below the threshold for single taxpayers ($157,500), she is allowed a QBI deduction. Further, she is not subject to the W–2 Wages/Capital Investment Limit. Her QBI deduction is $30,000, the lesser of:

1.	20% of qualified business income ($162,000 × 20%), or	$32,400
2.	20% of modified taxable income ($150,000 × 20%)	$30,000

b. As Jennifer has a "specified services" business and her taxable income before the QBI deduction exceeds $207,500 (the threshold for single taxpayers + $50,000), Jennifer is not entitled to a QBI deduction.

35. (LO 3, 4) Elliot and Julie's taxable income before the QBI deduction is $346,000 ($280,000 + $90,000 – $24,000 standard deduction); this is also their modified taxable income. Since their taxable income before the QBI deduction exceeds $315,000, the W–2 Wages/Capital Investment Limit must be considered. Elliot's QBI deduction is $56,000, determined as follows:

1.	20% of qualified business income ($280,000 × 20%)		$56,000
2.	But no more than the *greater of*:		
	• 50% of W–2 wages ($170,000 × 50%), or		$85,000
	• 25% of W–2 wages ($170,000 × 25%) plus	$42,500	
	• 2.5% of the unadjusted basis of qualified property ($140,000 × 2.5%)	3,500	$46,000
	And *no more than*:		
3.	20% of modified taxable income ($346,000 × 20%)		$69,200

The W–2 Wages/Capital Investment Limit does not apply, nor does the overall modified taxable income limitation. So Elliot's QBI deduction is $56,000.

36. (LO 3, 4)

a. Elliot and Julie's taxable income before the QBI deduction is $206,000 ($140,000 + $90,000 – $24,000); this is also their modified taxable income. However, because their taxable income before the QBI deduction is below the threshold for married taxpayers ($315,000), Elliot will be allowed a QBI deduction. Further, he is not subject to the W–2 Wages/Capital Investment Limit. His QBI deduction is $28,000, the lesser of:

1.	20% of qualified business income ($140,000 × 20%), or	$28,000
2.	20% of modified taxable income ($206,000 × 20%)	$41,200

b. Conrad and Jessica's taxable income is $428,000 ($140,000 + $350,000 – $62,000); this is also their modified taxable income. As their taxable income before the QBI deduction exceeds $415,000, they are not entitled to a QBI deduction. Here, other forms of income (his wife's wages) disqualify Conrad from being able to claim a QBI deduction. And even though both Elliot and Conrad have the same levels of equity and risk, only Elliot is able to claim a QBI deduction.

Research Problems 1 to 4

These research problems require that students utilize online resources to research and answer the questions. As a result, solutions may vary among students and courses. You should determine the skill and experience levels of the students before assigning these problems, coaching where necessary. Encourage students to use reliable websites and blogs of the IRS and other government agencies, media outlets, businesses, tax professionals, academics, think tanks, and political outlets to research their answers.

CHECK FIGURES

13.	$15,600.
14.	$175,000.
15.a.	$325,000.
15.b.	$225,000.
16.a.	$175,000.
16.b.	$275,000.
17.	$12,000.
18.	$22,000.
19.	$9,800.
20.a.	Each partner reports $55,000 net profit and long-term capital gain of $7,500.
20.b.	Same as part a.
20.c.	Corporation reports $125,000 income. Shareholders each report $25,000 dividend income.
21.a.	After-tax income $170,190.
21.b.	After-tax income $141,890.
21.c.	After-tax income $128,670.
22.	$40,000.
23.	$57,000.
24.	$148,000.
25.	$250,000.
26.	$36,000.
27.	None.
28.	$14,400.
29.	$20,000.
30.	$15,000.
31.	$50,000.
32.	$27,600.
33.	$31,100.
34.a.	$30,000.
34.b.	None.
35.	$56,000.
36.a.	$28,000.
36.b.	None.

SOUTHERN ILLINOIS UNIVERSITY

,
618-457-6731

January 21, 2019

Pet Kingdom, Inc.
1010 Northwest Parkway
Dallas, TX 75225
US

Dear Client:

Your 2018 Federal Corporation Income Tax Return will be electronically filed with the Internal Revenue Service upon receipt of a signed Form 8879C - IRS e-file Signature Authorization. No tax is payable with the filing of this return. You will receive a refund of $2,266.

All payments due must be electronically deposited through the Electronic Federal Tax Payment System (EFTPS). For EFTPS deposits to be made on time, the transaction must be initiated at least one business day before the date the deposit is due.

Your 2019 Texas Franchise Tax Return will be electronically filed with the State of Texas. There is a balance payable of $18,509. Mail the payment with Form 05-170 Texas Franchise Tax Payment Form on or before May 15, 2019. Write the Texas taxpayer identification number and the report year on the check or money order.

Make check payable to State Comptroller and mail to:

TEXAS COMPTROLLER OF PUBLIC ACCOUNTS
P.O. BOX 149348
AUSTIN, TX 78714-9348

Your estimated tax schedule for 2019 is listed below:

Due Date	Federal
4/15/19	$ 55,434
6/17/19	55,434
9/16/19	55,434
12/16/19	55,434

	$ 221,736

Please be sure to call if you have any questions.

Sincerely,

Raymond Wacker

Pet Kingdom, Inc. 11-1111112

INCOME	
Gross receipts less returns/allowance	5,550,000
Cost of goods sold	2,300,000
Gross Profit	3,250,000
Dividends	43,750
Interest	20,000
Total income	3,313,750
DEDUCTIONS	
Compensation of officers	525,000
Salaries/wages less employment credits	725,000
Repairs and maintenance	140,000
Rents	109,000
Taxes and licenses	238,000
Interest	207,000
Contributions	38,000
Depreciation	136,000
Advertising	58,000
Employee benefit programs	60,000
Total deductions	2,236,000
TAXABLE INCOME	
Taxable income (line 28)	1,077,750
Less special deductions	21,875
Taxable income	1,055,875
TAX COMPUTATION	
Income tax	221,734
Total tax	221,734
PAYMENTS AND CREDITS	
Estimated tax payments	224,000
Total payments and credits	224,000
REFUND OR AMOUNT DUE	
Overpayment	2,266
Tax due	0
Refund	2,266
SCHEDULE L	
Beginning Assets	13,714,000
Beginning Liabilities & Equity	13,714,000
Ending Assets	13,802,727
Ending Liabilities & Equity	13,802,727
TAX RATES	
Marginal tax rate	21.0%
Effective tax rate	21.0%

Pet Kingdom, Inc. 11-1111112

ENDING ASSETS

Cash		1,039,461
Accounts receivable	2,147,000	
Less: Allowance for bad debts	(0)	2,147,000
Inventories		3,030,000
Tax exempt securities		375,000
Other current assets		1,527,266
Buildings and other assets	5,455,000	
Less: Accumulated depreciation	(712,000)	4,743,000
Other assets		941,000
Total Assets		13,802,727

ENDING LIABILITIES & EQUITY

Accounts payable		1,840,711
Short term notes payable		4,575,000
Other current liabilities		155,000
Common stock	2,500,000	2,500,000
Unappropriated retained earnings		4,732,016
Total Liabilities and Equity		13,802,727

Pet Kingdom, Inc.

REVENUE

Gross receipts or sales	5,550,000
Dividend	43,750
Interest	20,000
Total gross revenue	5,613,750
Deductions from gross revenue	21,875
Total revenue	5,591,875

COST OF GOODS SOLD

Cost of goods sold	2,580,000
Total cost of goods sold	2,580,000

COMPENSATION

Wages and cash compensation	1,250,000
Employee benefits	60,000
Total compensation	1,310,000

MARGIN

Percent margin	3,914,312
COGS margin	3,011,875
Compensation margin	4,281,875
Less than 1 million margin	4,591,875
Margin	3,011,875

APPORTIONMENT FACTOR

Gross receipts in Texas	5,591,875
Gross receipts everywhere	5,591,875
Apportionment factor	1.00000

TAXABLE MARGIN

Apportioned margin	3,011,875
Taxable margin	3,011,875
Apportioned revenue (EZ computation)	5,591,875

TAX DUE

Tax rate	0.3310%

TAX ADJUSTMENTS

Tax due before discount	18,509

AMOUNT DUE AND PAYABLE

Total amount due and payable	18,509

TAX RATES

Marginal tax rate	0.6%
Effective tax rate	0.3%

Pet Kingdom, Inc. 11-1111112

Charitable Contribution Deduction

Total	$ 38,000.
Total	$ 38,000.

Computation of Net Income (Loss) Per Books
Form 1120, Schedule M-1, Line 1

Income (loss) per return (Page 1, line 28)	1,077,750.
Increases:	
Deductions on return not recorded on books (Sch. M-1, line 8)	30,000.
Income recorded on books not included on return (Sch. M-1, line 7)	15,000.
Decreases:	
Expenses recorded on books not deducted on return (Sch. M-1, line 5)	-49,000.
Income subject to tax not recorded on books (Sch. M-1, line 4)	0.
Excess of capital losses over capital gains (Sch. M-1, line 3)	0.
Federal income tax per books (Sch. M-1, line 2)	-221,734.
Computed net income (loss) per books (Sch. M-1, line 1)	852,016.
Less: Net income (loss) per books (memo only entry)	1,073,750.
Unreconciled difference	-221,734.

Texas Franchise Tax
Deductions From Gross Revenue

Schedule C dividends received	21,875.
Total deductions from gross revenue	21,875.

Texas Franchise Tax
Cost of Goods Sold

Purchases	2,580,000.
Total cost of goods sold	2,580,000.

Texas Franchise Tax
Wages and Cash Compensation

Salaries and wages, other than officers	725,000.
Janet Morton (Limited to $370,000)	262,500.
Kim Wong (Limited to $370,000)	262,500.
Total wages and cash compensation from reporting entity	1,250,000.
Total wages and cash compensation	1,250,000.

Texas Franchise Tax
Employee Benefits

Employee benefit programs	60,000.
Total employee benefits from reporting entity	60,000.
Total employee benefits	60,000.

Form **1120-W**

(WORKSHEET)

Department of the Treasury
Internal Revenue Service

Estimated Tax for Corporations

For calendar year 2019, or tax year beginning ____________ , 2019, and ending ____________ , ________

▸ Go to *www.irs.gov/Form1120W* for instructions and the latest information.

▸ Keep for the corporation's records — Do *not* send to the Internal Revenue Service.

OMB No. 1545-0123

2019

Name: Pet Kingdom, Inc.

Employer identification no. 11-1111112

Estimated Tax Computation

1	Taxable income expected for the tax year	1	1,055,875.
2	Multiply line 1 by 21% (0.21)	2	221,734.
3	Tax credits. See instructions	3	
4	Subtract line 3 from line 2	4	221,734.
5	Other taxes. See instructions	5	
6	**Total tax.** Add lines 4 and 5	6	221,734.
7	Credit for federal tax paid on fuels and other refundable credits. See instructions	7	
8	Subtract line 7 from line 6. **Note:** If the result is less than $500, the corporation is not required to make estimated tax payments	8	221,734.
9 a	Enter the tax shown on the corporation's 2018 tax return. See instructions. **Caution:** If the tax is zero or the tax year was for less than 12 months, skip this line and enter the amount from line 8 on line 9b	9a	221,734.
b	Enter the **smaller** of line 8 or line 9a. If the corporation is required to skip line 9a, enter the amount from line 8 (adjusted due to rounding)	9b	221,736.

			(a)	(b)	(c)	(d)
10	**Installment due dates.** See instructions ▸	10	4/15/19	6/17/19	9/16/19	12/16/19
11	**Required installments.** Enter 25% of line 9b in columns **(a)** through **(d)**. If the corporation uses the annualized income installment method or adjusted seasonal installment method or is a 'large corporation,' see the instructions for the amount to enter	11	55,434.	55,434.	55,434.	55,434.

Form **8879-C**

Department of the Treasury
Internal Revenue Service

IRS *e-file* Signature Authorization for Form 1120

For calendar year **2018**, or tax year beginning ____________ , **2018**, ending ____________ , ________

► **Do not send to the IRS. Keep for your records.**
► **Go to *www.irs.gov/Form8879C* for the latest information.**

OMB No. 1545-0123

2018

Name of corporation	Employer identification number
Pet Kingdom, Inc.	11-1111112

Part I **Tax Return Information** (Whole dollars only)

1	Total income (Form 1120, line 11)	1	3,313,750.
2	Taxable income (Form 1120, line 30)	2	1,055,875.
3	Total tax (Form 1120, line 31)	3	221,734.
4	Amount owed (Form 1120, line 35)	4	
5	Overpayment (Form 1120, line 36)	5	2,266.

Part II **Declaration and Signature Authorization of Officer. Be sure to get a copy of the corporation's return.**

Under penalties of perjury, I declare that I am an officer of the above corporation and that I have examined a copy of the corporation's 2018 electronic income tax return and accompanying schedules and statements and to the best of my knowledge and belief, it is true, correct, and complete. I further declare that the amounts in Part I above are the amounts shown on the copy of the corporation's electronic income tax return. I consent to allow my electronic return originator (ERO), transmitter, or intermediate service provider to send the corporation's return to the IRS and to receive from the IRS **(a)** an acknowledgement of receipt or reason for rejection of the transmission, **(b)** the reason for any delay in processing the return or refund, and **(c)** the date of any refund. If applicable, I authorize the U.S. Treasury and its designated Financial Agent to initiate an electronic funds withdrawal (direct debit) entry to the financial institution account indicated in the tax preparation software for payment of the corporation's federal taxes owed on this return, and the financial institution to debit the entry to this account. To revoke a payment, I must contact the U.S. Treasury Financial Agent at **1-888-353-4537** no later than 2 business days prior to the payment (settlement) date. I also authorize the financial institutions involved in the processing of the electronic payment of taxes to receive confidential information necessary to answer inquiries and resolve issues related to the payment. I have selected a personal identification number (PIN) as my signature for the corporation's electronic income tax return and, if applicable, the corporation's consent to electronic funds withdrawal.

Officer's PIN: check one box only

[X] I authorize ______________________________ to enter my PIN ______________ as my signature
ERO firm name **do not enter all zeros**
on the corporation's 2018 electronically filed income tax return.

[DO NOT FILE]

[ ] As an officer of the corporation, I will enter my PIN as my signature on the corporation's 2018 electronically filed income tax return.

Officer's signature ► ______________________ Date ► ____________ Title ► ____________

Part III **Certification and Authentication**

ERO's EFIN/PIN. Enter your six-digit EFIN followed by your five-digit self-selected PIN. ______________
do not enter all zeros

I certify that the above numeric entry is my PIN, which is my signature on the 2018 electronically filed income tax return for the corporation indicated above. I confirm that I am submitting this return in accordance with the requirements of **Pub. 3112,** IRS *e-file* Application and Participation, and **Pub. 4163,** Modernized e-File (MeF) Information for Authorized IRS *e-file* Providers for Business Returns.

ERO's signature ► ______________________ Date ► ____________

ERO Must Retain This Form — See Instructions
Do Not Submit This Form to the IRS Unless Requested To Do So

Form **1120**

Department of the Treasury
Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 2018 or tax year beginning __________ , 2018, ending __________ , ________

► **Go to *www.irs.gov/Form1120* for instructions and the latest information.**

OMB No. 1545-0123

2018

A Check if:

1 a	Consolidated return (attach Form 851)	☐
b	Life/nonlife consolidated return	☐
2	Personal holding co. (attach Sch. PH)	☐
3	Personal service corp. (see instrs)	☐
4	Schedule M-3 attached	X

TYPE OR PRINT

Pet Kingdom, Inc.
1010 Northwest Parkway
Dallas, TX 75225 US

B Employer identification number: 11-1111112

C Date incorporated: 11/01/2008

D Total assets (see instructions): $ 13,802,727.

E Check if: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Name change (4) ☐ Address change

INCOME

1 a	Gross receipts or sales	1 a	5,750,000.		
b	Returns and allowances	1 b	200,000.		
c	Balance. Subtract line 1b from line 1a			1 c	5,550,000.
2	Cost of goods sold (attach Form 1125-A)			2	2,300,000.
3	Gross profit. Subtract line 2 from line 1c			3	3,250,000.
4	Dividends and inclusions (Schedule C, line 23, column (a))			4	43,750.
5	Interest			5	20,000.
6	Gross rents			6	
7	Gross royalties			7	
8	Capital gain net income (attach Schedule D (Form 1120))			8	
9	Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797)			9	
10	Other income (see instructions — attach statement)			10	
11	**Total income.** Add lines 3 through 10 ►			11	3,313,750.

DEDUCTIONS (SEE INSTRUCTIONS FOR LIMITATIONS ON DEDUCTIONS)

12	Compensation of officers (see instructions — attach Form 1125-E) ►			12	525,000.
13	Salaries and wages (less employment credits)			13	725,000.
14	Repairs and maintenance			14	140,000.
15	Bad debts			15	
16	Rents			16	109,000.
17	Taxes and licenses			17	238,000.
18	Interest (see instructions)			18	207,000.
19	Charitable contributions			19	38,000.
20	Depreciation from Form 4562 not claimed on Form 1125-A or elsewhere on return (attach Form 4562)			20	136,000.
21	Depletion			21	
22	Advertising			22	58,000.
23	Pension, profit-sharing, etc., plans			23	
24	Employee benefit programs			24	60,000.
25	Reserved for future use			25	
26	Other deductions (attach statement)			26	
27	**Total deductions.** Add lines 12 through 26 ►			27	2,236,000.
28	Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11			28	1,077,750.
29 a	Net operating loss deduction (see instructions)	29 a			
b	Special deductions (Schedule C, line 24, column (c))	29 b	21,875.		
c	Add lines 29a and 29b			29 c	21,875.

[DO NOT FILE]

TAX, REFUNDABLE CREDITS, AND PAYMENTS

30	**Taxable income.** Subtract line 29c from line 28. See instructions	30	1,055,875.
31	Total tax (Schedule J, Part I, line 11)	31	221,734.
32	2018 net 965 tax liability paid (Schedule J, Part II, line 12)	32	
33	Total payments, credits, and section 965 net tax liability (Schedule J, Part III, line 23)	33	224,000.
34	Estimated tax penalty. See instructions. Check if Form 2220 is attached ► ☐	34	
35	**Amount owed.** If line 33 is smaller than the total of lines 31, 32, and 34, enter amount owed	35	
36	**Overpayment.** If line 33 is larger than the total of lines 31, 32, and 34, enter amount overpaid	36	2,266.
37	Enter amount from line 36 you want: **Credited to 2019 estimated tax** ► 2,266. **Refunded** ►	37	

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

► Signature of officer | Date | ► Title

May the IRS discuss this return with the preparer shown below? See instructions. ☐ Yes ☐ No

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
	Self-Prepared			

Firm's name ► | Firm's EIN ►

Firm's address ► | Phone no.

BAA For Paperwork Reduction Act Notice, see separate instructions. CPCA0212L 01/04/19 Form **1120** (2018)

Schedule C **Dividends, Inclusions, and Special Deductions** (see instructions)

		(a) Dividends and inclusions	(b) Percentage	(c) Special deductions (a) x (b)
1	Dividends from less-than-20%-owned domestic corporations (other than debt-financed stock)	43,750.	50	21,875.
2	Dividends from 20%-or-more-owned domestic corporations (other than debt-financed stock)		65	
3	Dividends on certain debt-financed stock of domestic and foreign corporations		see instructions	
4	Dividends on certain preferred stock of less-than-20%-owned public utilities		23.3	
5	Dividends on certain preferred stock of 20%-or-more-owned public utilities		26.7	
6	Dividends from less-than-20%-owned foreign corporations and certain FSCs		50	
7	Dividends from 20%-or-more-owned foreign corporations and certain FSCs		65	
8	Dividends from wholly owned foreign subsidiaries		100	
9	**Subtotal.** Add lines 1 through 8. See instructions for limitations	43,750.	see instructions	21,875.
10	Dividends from domestic corporations received by a small business investment company operating under the Small Business Investment Act of 1958		100	
11	Dividends from affiliated group members		100	
12	Dividends from certain FSCs		100	
13	Foreign-source portion of dividends received from a specified 10%-owned foreign corporation (excluding hybrid dividends) (see instructions)		100	
14	Dividends from foreign corporations not included on line 3, 6, 7, 8, 11, 12, or 13 (including any hybrid dividends)			
15	Section 965(a) inclusion		see instructions	
16a	Subpart F inclusions derived from the sale by a controlled foreign corporation (CFC) of the stock of a lower-tier foreign corporation treated as a dividend (attach Form(s) 5471) (see instructions)		100	
b	Subpart F inclusions derived from hybrid dividends of tiered corporations (attach Form(s) 5471) (see instructions)			
c	Other inclusions from CFCs under subpart F not included on line 15, 16a, 16b, or 17 (attach Form(s) 5471) (see instructions)			
17	Global Intangible Low-Taxed Income (GILTI) (attach Form(s) 5471 and Form 8992)			
18	Gross-up for foreign taxes deemed paid			
19	IC-DISC and former DISC dividends not included on line 1, 2, or 3			
20	Other dividends			
21	Deduction for dividends paid on certain preferred stock of public utilities			
22	Section 250 deduction (attach Form 8993)			
23	**Total dividends and inclusions.** Add lines 9 through 20. Enter here and on page 1, line 4	43,750.		
24	**Total special deductions.** Add lines 9 through 22, column (c). Enter here and on page 1, line 29b			21,875.

CPCA0212L 08/21/18

Schedule J Tax Computation and Payment (see instructions)

Part I — Tax Computation

1	Check if the corporation is a member of a controlled group (attach Schedule O (Form 1120)). See instructions ► ☐			
2	Income tax. See instructions		2	221,734.
3	Base erosion minimum tax (attach Form 8991)		3	
4	Add lines 2 and 3		4	221,734.
5 a	Foreign tax credit (attach Form 1118)	5 a		
b	Credit from Form 8834 (see instructions)	5 b		
c	General business credit (attach Form 3800)	5 c		
d	Credit for prior year minimum tax (attach Form 8827)	5 d		
e	Bond credits from Form 8912	5 e		
6	**Total credits.** Add lines 5a through 5e		6	
7	Subtract line 6 from line 4		7	221,734.
8	Personal holding company tax (attach Schedule PH (Form 1120))		8	
9 a	Recapture of investment credit (attach Form 4255)	9 a		
b	Recapture of low-income housing credit (attach Form 8611)	9 b		
c	Interest due under the look-back method — completed long-term contracts (attach Form 8697)	9 c		
d	Interest due under the look-back method — income forecast method (attach Form 8866)	9 d		
e	Alternative tax on qualifying shipping activities (attach Form 8902)	9 e		
f	Other (see instructions — attach statement)	9 f		
10	**Total.** Add lines 9a through 9f		10	
11	**Total tax.** Add lines 7, 8, and 10. Enter here and on page 1, line 31		11	221,734.

Part II — Section 965 Payments (see instructions)

12	2018 net 965 tax liability paid from Form 965-B, Part II, column (k), line 2. Enter here and on page 1, line 32	12	

Part III — Payments and Refundable Credits, and Section 965 Net Tax Liability

13	2017 overpayment credited to 2018		13	
14	2018 estimated tax payments		14	224,000.
15	2018 refund applied for on Form 4466		15	
16	Combine lines 13, 14, and 15		16	224,000.
17	Tax deposited with Form 7004		17	
18	Withholding (see instructions)		18	
19	**Total payments.** Add lines 16, 17, and 18		19	224,000.
20	Refundable credits from:			
a	Form 2439	20 a		
b	Form 4136	20 b		
c	Form 8827, line 8c	20 c		
d	Other (attach statement — see instructions)	20 d		
21	**Total credits.** Add lines 20a through 20d		21	
22	2018 net 965 tax liability from Form 965-B, Part I, column (d), line 2. See instructions		22	
23	**Total payments, credits, and section 965 net tax liability.** Add lines 19, 21, and 22. Enter here and on page 1, line 33		23	224,000.

Schedule K Other Information (see instructions)

		Yes	No
1	Check accounting method: a ☐ Cash b ☒ Accrual c ☐ Other (specify) ►		
2	See the instructions and enter the:		
a	Business activity code no. ►		
b	Business activity ► Retail		
c	Product or service ► Pet Supplies		
3	Is the corporation a subsidiary in an affiliated group or a parent-subsidiary controlled group? If "Yes," enter name and EIN of the parent corporation ►		X
4	At the end of the tax year:		
a	Did any foreign or domestic corporation, partnership (including any entity treated as a partnership), trust, or tax-exempt organization own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote? If "Yes," complete Part I of Schedule G (Form 1120) (attach Schedule G)		X
b	Did any individual or estate own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote? If "Yes," complete Part II of Schedule G (Form 1120) (attach Schedule G)	X	
5	At the end of the tax year, did the corporation:		
a	Own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of stock entitled to vote of any foreign or domestic corporation not included on **Form 851,** Affiliations Schedule? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (iv) below.		X

(i) Name of Corporation	**(ii)** Employer Identification Number (if any)	**(iii)** Country of Incorporation	**(iv)** Percentage Owned in Voting Stock

		Yes	No
b	Own directly an interest of 20% or more, or own, directly or indirectly, an interest of 50% or more in any foreign or domestic partnership (including an entity treated as a partnership) or in the beneficial interest of a trust? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (iv) below.		X

[DO NOT FILE]

(i) Name of Entity	**(ii)** Employer Identification Number (if any)	**(iii)** Country of Organization	**(iv)** Maximum Percentage Owned in Profit, Loss, or Capital

		Yes	No
6	During this tax year, did the corporation pay dividends (other than stock dividends and distributions in exchange for stock) in excess of the corporation's current and accumulated earnings and profits? See sections 301 and 316. If "Yes," file **Form 5452**, Corporate Report of Nondividend Distributions. See the instructions for Form 5452. If this is a consolidated return, answer here for the parent corporation and on Form 851 for each subsidiary.		X
7	At any time during the tax year, did one foreign person own, directly or indirectly, at least 25% of the total voting power of all classes of the corporation's stock entitled to vote or at least 25% of the total value of all classes of the corporation's stock? For rules of attribution, see section 318. If "Yes," enter: **(a)** Percentage owned ► and **(b)** Owner's country ► **(c)** The corporation may have to file **Form 5472,** Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. Enter the number of Forms 5472 attached ►		X
8	Check this box if the corporation issued publicly offered debt instruments with original issue discount ► ☐ If checked, the corporation may have to file **Form 8281**, Information Return for Publicly Offered Original Issue Discount Instruments.		
9	Enter the amount of tax-exempt interest received or accrued during the tax year ► $ 15,000.		
10	Enter the number of shareholders at the end of the tax year (if 100 or fewer) ► 2		
11	If the corporation has an NOL for the tax year and is electing to forego the carryback period, check here (see instructions) ► ☐ If the corporation is filing a consolidated return, the statement required by Regulations section 1.1502-21(b)(3) must be attached or the election will not be valid.		
12	Enter the available NOL carryover from prior tax years (do not reduce it by any deduction reported on page 1, line 29a.) ► $ None		

Schedule K **Other Information** *(continued from page 4)*

		Yes	No
13	Are the corporation's total receipts (page 1, line 1a, plus lines 4 through 10) for the tax year **and** its total assets at the end of the tax year less than $250,000?		X
	If "Yes," the corporation is not required to complete Schedules L, M-1, and M-2. Instead, enter the total amount of cash distributions and the book value of property distributions (other than cash) made during the tax year ►$		
14	Is the corporation required to file Schedule UTP (Form 1120), Uncertain Tax Position Statement? See instructions. If "Yes," complete and attach Schedule UTP.		X
15a	Did the corporation make any payments in 2018 that would require it to file Form(s) 1099?		X
b	If "Yes," did or will the corporation file required Forms 1099?		
16	During this tax year, did the corporation have an 80% or more change in ownership, including a change due to redemption of its own stock?		X
17	During or subsequent to this tax year, but before the filing of this return, did the corporation dispose of more than 65% (by value) of its assets in a taxable, non-taxable, or tax deferred transaction?		X
18	Did the corporation receive assets in a section 351 transfer in which any of the transferred assets had a fair market basis or fair market value of more than $1 million?		X
19	During the corporation's tax year, did the corporation make any payments that would require it to file Forms 1042 and 1042-S under chapter 3 (sections 1441 through 1464) or chapter 4 (sections 1471 through 1474) of the Code?		X
20	Is the corporation operating on a cooperative basis?		X
21	During the tax year, did the corporation pay or accrue any interest or royalty for which the deduction is not allowed under section 267A? See instructions		X
	If "Yes," enter the total amount of the disallowed deductions ►$		
22	Does the corporation have gross receipts of at least $500 million in any of the 3 preceding tax years? (See sections 59A(e)(2) and (3))		X
	If "Yes," complete and attach Form 8991.		
23	Did the corporation have an election under section 163(j) for any real property trade or business or any farming business in effect during the tax year? See instructions		X
24	Does the corporation satisfy one of the following conditions and the corporation does not own a pass-through entity with current year, or prior year carryover, excess business interest expense? See instructions	X	
a	The corporation's aggregate average annual gross receipts (determined under section 448(c)) for the 3 tax years preceding the current tax year do not exceed $25 million, and the corporation is not a tax shelter, or		
b	The corporation only has business interest expense from (1) an electing real property trade or business, (2) an electing farming business, or (3) certain utility businesses under section 163(j)(7). If "No," complete and attach Form 8990.		
25	Is the corporation attaching Form 8996 to certify as a Qualified Opportunity Fund?		X
	If "Yes," enter amount from Form 8996, line 13 ►$		

Schedule L **Balance Sheets per Books**

Assets	Beginning of tax year (a)	(b)	End of tax year (c)	(d)
1 Cash		1,200,000.		1,039,461.
2a Trade notes and accounts receivable	2,062,500.		2,147,000.	
b Less allowance for bad debts		2,062,500.		2,147,000.
3 Inventories		2,750,000.		3,030,000.
4 U.S. government obligations				
5 Tax-exempt securities (see instructions)		375,000.		375,000.
6 Other current assets (attach statement) See St 1		1,525,000.		1,527,266.
7 Loans to shareholders				
8 Mortgage and real estate loans				
9 Other investments (attach statement)				
10a Buildings and other depreciable assets	5,455,000.		5,455,000.	
b Less accumulated depreciation	606,000.	4,849,000.	712,000.	4,743,000.
11a Depletable assets				
b Less accumulated depletion				
12 Land (net of any amortization)				
13a Intangible assets (amortizable only)				
b Less accumulated amortization				
14 Other assets (attach statement) See St 2		952,500.		941,000.
15 Total assets		13,714,000.		13,802,727.
Liabilities and Shareholders' Equity				
16 Accounts payable		2,284,000.		1,840,711.
17 Mortgages, notes, bonds payable in less than 1 year		4,625,000.		4,575,000.
18 Other current liabilities (attach stmt) See St 3		175,000.		155,000.
19 Loans from shareholders				
20 Mortgages, notes, bonds payable in 1 year or more				
21 Other liabilities (attach statement)				
22 Capital stock: a Preferred stock				
b Common stock	2,500,000.	2,500,000.	2,500,000.	2,500,000.
23 Additional paid-in capital				
24 Retained earnings — Approp (att stmt)				
25 Retained earnings — Unappropriated		4,130,000.		4,732,016.
26 Adjmt to shareholders' equity (att stmt)				
27 Less cost of treasury stock				
28 Total liabilities and shareholders' equity		13,714,000.		13,802,727.

Schedule M-1 **Reconciliation of Income (Loss) per Books With Income per Return**

Note: The corporation may be required to file Schedule M-3. See instructions.

1 Net income (loss) per books	852,016.	7 Income recorded on books this year not included on this return (itemize): Tax-exempt interest $ 15,000.	15,000.
2 Federal income tax per books	221,734.		
3 Excess of capital losses over capital gains		8 Deductions on this return not charged against book income this year (itemize):	
4 Income subject to tax not recorded on books this year (itemize):		a Depreciation $ 30,000.	
5 Expenses recorded on books this year not deducted on this return (itemize):		b Charitable contribns $	
a Depreciation $			
b Charitable contributions $			
c Travel & entertainment $			
Statement 4 49,000.	49,000.		30,000.
		9 Add lines 7 and 8	45,000.
6 Add lines 1 through 5	1,122,750.	10 Income (page 1, line 28) — line 6 less line 9	1,077,750.

Schedule M-2 **Analysis of Unappropriated Retained Earnings per Books (Line 25, Schedule L)**

1 Balance at beginning of year	4,130,000.	5 Distributions: a Cash	250,000.
2 Net income (loss) per books	852,016.	b Stock c Property	
3 Other increases (itemize):		6 Other decreases (itemize):	
		7 Add lines 5 and 6	250,000.
4 Add lines 1, 2, and 3	4,982,016.	8 Balance at end of year (line 4 less line 7)	4,732,016.

Form **1125-A** (Rev. November 2018) Department of the Treasury Internal Revenue Service

Cost of Goods Sold

► **Attach to Form 1120, 1120-C, 1120-F, 1120S, or 1065.**
► **Go to *www.irs.gov/Form1125A* for the latest information.**

OMB No. 1545-0123

Name	Employer identification number
Pet Kingdom, Inc.	11-1111112

1	Inventory at beginning of year	1	2,750,000.
2	Purchases	2	2,580,000.
3	Cost of labor	3	
4	Additional section 263A costs (attach schedule)	4	
5	Other costs (attach schedule)	5	
6	**Total.** Add lines 1 through 5	6	5,330,000.
7	Inventory at end of year	7	3,030,000.
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on Form 1120, page 1, line 2 or the appropriate line of your tax return. See instructions	8	2,300,000.

9 a Check all methods used for valuing closing inventory:

(i) [X] Cost
(ii) [X] Lower of cost or market
(iii) [ ] Other (Specify method used and attach explanation.) ► ______

b Check if there was a writedown of subnormal goods ► [ ]

c Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ► [ ]

d If the LIFO inventory method was used for this tax year, enter amount of closing inventory computed under LIFO **9d**

e If property is produced or acquired for resale, do the rules of section 263A apply to the entity? See instructions [ ] Yes [X] No

f Was there any change in determining quantities, cost, or valuations between opening and closing inventory? If "Yes," attach explanation [ ] Yes [X] No

SCHEDULE G
(Form 1120)
(Rev December 2011)
Department of the Treasury
Internal Revenue Service

Information on Certain Persons Owning the Corporation's Voting Stock

► **Attach to Form 1120.**
► **See instructions.**

OMB No. 1545-0123

Name: Pet Kingdom, Inc.

Employer identification number (EIN): 11-1111112

Part I **Certain Entities Owning the Corporation's Voting Stock.** (Form 1120, Schedule K, Question 4a). Complete columns (i) through (v) below for any foreign or domestic corporation, partnership (including any entity treated as a partnership), trust, or tax-exempt organization that owns directly 20% or more, or owns, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote (see instructions).

(i) Name of Entity	(ii) Employer Identification Number (if any)	(iii) Type of Entity	(iv) Country of Organization	(v) Percentage Owned in Voting Stock

Part II **Certain Individuals and Estates Owning the Corporation's Voting Stock.** (Form 1120, Schedule K, Question 4b). Complete columns (i) through (iv) below for any individual or estate that owns directly 20% or more, or owns, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote (see instructions).

(i) Name of Individual or Estate	(ii) Identifying Number (if any)	(iii) Country of Citizenship (see instructions)	(iv) Percentage Owned in Voting Stock
Janet Morton	123-45-6788	United States	50.00%
Kim Wong	123-45-6787	United States	50.00%

SCHEDULE M-3 (Form 1120)

Department of the Treasury
Internal Revenue Service

Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More

► Attach to Form 1120 or 1120-C.
► Go to *www.irs.gov/Form1120* for instructions and the latest information.

OMB No. 1545-0123

2018

Name of corporation (common parent, if consolidated return): Pet Kingdom, Inc.

Employer identification number: 11-1111112

Check applicable box(es): (1) [X] Non-consolidated return (2) [ ] Consolidated return (Form 1120 only)
(3) [ ] Mixed 1120/L/PC group (4) [ ] Dormant subsidiaries schedule attached

Part I Financial Information and Net Income (Loss) Reconciliation (see instructions)

1 a Did the corporation file SEC Form 10-K for its income statement period ending with or within this tax year?
[ ] **Yes.** Skip lines 1b and 1c and complete lines 2a through 11 with respect to that SEC Form 10-K.
[X] **No.** Go to line 1b. See instructions if multiple non-tax-basis income statements are prepared.

b Did the corporation prepare a certified audited non-tax-basis income statement for that period?
[ ] **Yes.** Skip line 1c and complete lines 2a through 11 with respect to that income statement.
[X] **No.** Go to line 1c.

c Did the corporation prepare a non-tax-basis income statement for that period?
[X] **Yes.** Complete lines 2a through 11 with respect to that income statement.
[ ] **No.** Skip lines 2a through 3c and enter the corporation's net income (loss) per its books and records on line 4a.

2 a Enter the income statement period: Beginning 1/01/18 Ending 12/31/18

b Has the corporation's income statement been restated for the income statement period on line 2a?
[ ] **Yes.** (If 'Yes', attach an explanation and the amount of each item restated.)
[X] **No.**

c Has the corporation's income statement been restated for any of the five income statement periods immediately preceding the period on line 2a?
[ ] **Yes.** (If 'Yes', attach an explanation and the amount of each item restated.)
[X] **No.**

3 a Is any of the corporation's voting common stock publicly traded?
[ ] **Yes.**
[X] **No.** If 'No', go to line 4a.

b Enter the symbol of the corporation's primary U.S. publicly traded voting common stock. . . . .

c Enter the nine-digit CUSIP number of the corporation's primary publicly traded voting common stock. . . . .

4 a Worldwide consolidated net income (loss) from income statement source identified in Part I, line 1	4 a	852,016.
b Indicate accounting standard used for line 4a (see instructions): (1) [X] GAAP (2) [ ] IFRS (3) [ ] Statutory (4) [ ] Tax-basis (5) [ ] Other (specify)		
5 a Net income from nonincludible foreign entities (attach statement)	5 a	
b Net loss from nonincludible foreign entities (attach statement and enter as a positive amount)	5 b	
6 a Net income from nonincludible U.S. entities (attach statement)	6 a	
b Net loss from nonincludible U.S. entities (attach statement and enter as a positive amount)	6 b	
7 a Net income (loss) of other includible foreign disregarded entities (attach statement)	7 a	
b Net income (loss) of other includible U.S. disregarded entities (attach statement)	7 b	
c Net income (loss) of other includible entities (attach statement)	7 c	
8 Adjustment to eliminations of transactions between includible entities and nonincludible entities (attach statement)	8	
9 Adjustment to reconcile income statement period to tax year (attach statement)	9	
10 a Intercompany dividend adjustments to reconcile to line 11 (attach statement)	10 a	
b Other statutory accounting adjustments to reconcile to line 11 (attach statement)	10 b	
c Other adjustments to reconcile to amount on line 11 (attach statement)	10 c	
11 **Net income (loss) per income statement of includible corporations.** Combine lines 4 through 10	11	852,016.

Note: Part I, line 11, must equal Part II, line 30, column (a), or Schedule M-1, line 1 (see instructions).

12 Enter the total amount (not just the corporation's share) of the assets and liabilities of all entities included or removed on the following lines.

	Total Assets	Total Liabilities
a Included on Part I, line 4 ►	13,714,000.	13,802,727.
b Removed on Part I, line 5 ►		
c Removed on Part I, line 6 ►		
d Included on Part I, line 7 ►		

Form **1125-E**
(Rev October 2016)
Department of the Treasury
Internal Revenue Service

Compensation of Officers

► **Attach to Form 1120, 1120-C, 1120-F, 1120-REIT, 1120-RIC, or 1120S.**
► Information about Form 1125-E and its separate instructions is at ***www.irs.gov/form1125e.***

OMB No. 1545-0123

Name: Pet Kingdom, Inc.

Employer identification number: 11-1111112

Note: Complete Form 1125-E only if total receipts are $500,000 or more. See instructions for definition of total receipts.

1 (a) Name of officer	(b) Social security number	(c) Percent of time devoted to business	Percent of stock owned (d) Common	Percent of stock owned (e) Preferred	(f) Amount of compensation
Janet Morton	123-45-6788	000.00 %	50.00 %	0.00 %	262,500.
Kim Wong	123-45-6787	000.00 %	50.00 %	0.00 %	262,500.
		%	%	%	
		%	%	%	
		%	%	%	
		%	%	%	
		%	%	%	
		%	%	%	
		%	%	%	
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		%	%	%	
		%	%	%	
		%	%	%	
		%	%	%	
		%	%	%	
		%	%	%	
		%	%	%	

[DO NOT FILE]

2 Total compensation of officers	525,000.
3 Compensation of officers claimed on Form 1125-A or elsewhere on return	
4 Subtract line 3 from line 2. Enter the result here and on Form 1120, page 1, line 12 or the appropriate line of your tax return	525,000.

BAA For Paperwork Reduction Act Notice, see separate instructions. Form **1125-E** (Rev 10-2016)

CPCA2101L 08/18/16

Statement 1
Form 1120, Schedule L, Line 6
Other Current Assets

	Beginning	Ending
Certificate of Deposit	$ 400,000.	$ 400,000.
Prepaid Federal Tax	0.	2,266.
Stock Investment	1,125,000.	1,125,000.
Total	$ 1,525,000.	$ 1,527,266.

Statement 2
Form 1120, Schedule L, Line 14
Other Assets

	Beginning	Ending
Land	$ 812,500.	$ 812,500.
Other Assets	140,000.	128,500.
Total	$ 952,500.	$ 941,000.

Statement 3
Form 1120, Schedule L, Line 18
Other Current Liabilities

	Beginning	Ending
Other Current Liabilities	$ 175,000.	$ 155,000.
Total	$ 175,000.	$ 155,000.

Statement 4
Form 1120, Schedule M-1, Line 5
Book Expenses Not Deducted

Interest	$ 9,000.
Officer Life Insurance Premiums	40,000.
Total	$ 49,000.

Pursuant to requirements by the Texas Comptroller's Office, certain required input must be present and correct before the tax program will generate printable Texas forms. Please resolve all Texas Critical Diagnostics reported on the Diagnostics tab so that Texas forms may be viewable in the tax program.

7011

Pursuant to requirements by the Texas Comptroller's Office, certain required input must be present and correct before the tax program will generate printable Texas forms. Please resolve all Texas Critical Diagnostics reported on the Diagnostics tab so that Texas forms may be viewable in the tax program.

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7011

CHAPTER 2

THE DEDUCTION FOR QUALIFIED BUSINESS INCOME FOR PASS-THROUGH ENTITIES

LECTURE NOTES

OVERVIEW

For Federal income tax purposes, the distinctions among forms of business organization are critical. This chapter discusses the tax treatment of sole proprietorships, partnerships, S corporations, regular corporations, and limited liability companies. It also discusses the deduction added to the Federal tax law by the Tax Cuts and Jobs Act (TCJA) of 2017. Key topics include the changes due to TCJA of 2017 and how they affect tax liabilities as well as planning, such as for the form of business organization, that taxpayers should consider.

SUMMARY OF CHANGES IN THE CHAPTER

The following are notable changes in the chapter from the 2018 Edition. For major changes, see the Preface of the text.

- NEW chapter covering both an introduction to entities and the new deduction for qualified business income (§ 199A).
- Added extensive coverage of the QBI deduction, including a Concept Summary and multiple examples to assist students in navigating this challenging provision.
- Developed significant end-of-chapter materials illustrating the § 199A rules (including Discussion Questions, Computational Exercises, Problems, and Research Problems).

THE BIG PICTURE

When Amy graduates from college, she plans to use her knowledge to start businesses. She will generate income from advertising on her social media sites and will use her artistic and marketing talents to find work using several web platforms. Amy is wondering if she should form a corporation or a limited liability company or just be a sole proprietor. She is also curious whether, for tax and legal purposes, she should set her activities up as one business or two.

After reading this chapter, you can help Amy with her questions, including aiding her in better framing the questions should she decide to seek assistance from an attorney on business entity formation matters, or a CPA for tax and accounting assistance.

TAX TREATMENT OF VARIOUS BUSINESS FORMS

1. Business forms include sole proprietorships, partnerships (covered in Chapters 10 and 11), S corporations (covered in Chapter 12), regular corporations, and limited liability companies.

2. 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 percent to 35 percent) to a flat tax of 21 percent.

3. For businesses that do not operate as regular corporations, the TCJA of 2017 allows a special deduction for noncorporate taxpayers with business income.

Sole Proprietorships

4. 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.

5. The proprietor reports all the net profit from the business, regardless of the amount actually withdrawn during the year.

6. 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.

7. Beginning in 2018, 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.

Partnerships

8. Partnerships are tax-reporting, but not taxpaying, entities. A partnership reports its income on Form 1065.

9. 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.

   a. Schedule K–1 items are reported on each partner's tax return. (See Example 2 in the text.)

   b. Individual partners can claim the deduction for qualified business income (to the extent available) on his or her Form 1040.

Corporations

10. There are two types of corporations for tax purposes: corporations governed by Subchapter C (C corporations) and corporations governed by Subchapter S (S corporations).

11. S corporations have the following characteristics:

    a. Generally, they do not pay Federal income taxes.

    b. Similar to partnerships in that operating 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.

    c. Income and expense items "pass through" to shareholders, who report their share of the partnership items on their own returns. Items are allocated to shareholders according to their stock ownership interests.

12. Regular C corporations are subject to entity-level taxation. Other characteristics include:

    a. A C corporation reports its income and expenses on Form 1120.

    b. 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.

    c. 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."

13. Taxation of Dividends.

    a. Closely held corporation shareholders try to convert dividend distributions into tax-deductible expenses.

       (1) One common way is to increase compensation to shareholder-employees.

       (2) The IRS scrutinizes compensation and other economic transactions (e.g., loans, leases, and sales) between closely held corporations and their shareholders for reasonableness.

b. 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).

14. 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.

a. *Tax Rates.* Due to the TCJA of 2017, a flat rate of 21% applies to corporate taxable income for taxable years beginning after 2017.

(1) Historically, a graduated corporate tax rate structure was applied for corporations that ranged from 15% to 39% (flat 35% over $18,333,333). (See Exhibit 2.1 in the text.)

(2) 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.)

(3) 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.

(4) To explore the various tax situations, see Examples 5, 6, and 7 in the text.

b. *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.

c. *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 8 in the text.)

d. *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.

(1) Wages paid to a shareholder-employee of a C or S corporation are subject to payroll taxes.

(2) A deduction is available to an individual for part of self-employment taxes paid.

e. *State Taxes.* At the entity level:

(1) State corporate income taxes and/or franchise taxes are applicable to corporations.

(2) 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.

(3) At the owner level, the income of sole proprietorships, S corporations, and partnerships (along with dividend distributions) is subject to state individual income taxation.

f. The tax attributes of the various forms of business entities are compared in Concept Summary 2.1 in the text.

15. 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.

Limited Liability Companies

16. A limited liability company (LLC) offers a very important nontax advantage (unlimited 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.

a. All 50 states and the District of Columbia recognize LLCs.

b. LLC owners are called members.

c. 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.

17. Entity Classification. The IRS eased the entity classification problem by issuing check-the-box Regulations.

    a. Regulations enable taxpayers to choose the tax status of a business entity without regard to its corporate or noncorporate characteristics.

    b. Under these Regulations, an unincorporated entity with more than one owner is by default classified as a partnership.

    c. An unincorporated entity with only one owner is, by default, classified as a disregarded entity (DRE) and treated as a sole proprietor.

    d. If an entity wants to use its default status, it simply files the appropriate tax return.

    e. 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).

    f. 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).

        (1) An LLC can therefore be taxed as a C corporation or S corporation.

        (2) Since LLCs are not treated as being incorporated under state law, they default to partnership or DRE status.

THE TAX CUTS AND JOBS ACT (TCJA) OF 2017 AND ENTITY TAX RATES

18. A primary goal for tax reform in 2017 was to lower the Federal income tax rate for C corporations, improving the international competitiveness of U.S. corporations and attracting investment in the United States from non-U.S. multinational corporations.

Challenges of Lowering Tax Rates

19. The Tax Reform Act of 1986 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.

    a. After many years, most of these countries had lowered their rate below 34%, while the United States raised the top corporate rate to 35%.

    b. With U.S. companies facing increasing global competition, most members of Congress and U.S. Presidents favored lowering the corporate tax rate.

20. One obstacle in lowering tax rates is the related reduction in revenues for the Federal government.

21. Another obstacle to lowering the Federal corporate income tax rate is that most businesses in the United States operate as sole proprietorships, partnerships, or S corporations, rather than as C corporations.

Lowering Tax Rates for Different Business Forms

22. There is more than one way to lower the tax rate on the business income noncorporate taxpayers earn from their businesses.

    a. An alternative rate structure could be applied to business income.

    b. 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).

23. 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.

24. Leading up to the TCJA of 2017, the reasonable compensation approach was considered in the proposals of the Tax Reform Act of 2014 and the House Republican Tax Reform Blueprint released in June 2016.

25. In the discussions in late 2017 that led to enactment of the TCJA of 2017, both the reasonable compensation approach (in the House bill) and business deduction approach (in the Senate bill) were debated. Ultimately, the business deduction approach was selected.

    a. Under the TCJA of 2017, § 199A (Qualified Business Income) was added to the Internal Revenue Code, allowing up to a 20% deduction on the qualified business income of noncorporate taxpayers.

    b. As with most of the changes made by the TCJA of 2017 for individuals, the deduction for qualified business income is temporary; it is in effect from 2018 through 2025.

26. The purpose of the deduction is to reduce the tax on business income derived outside of the C corporate form.

THE DEDUCTION FOR QUALIFIED BUSINESS INCOME

27. With the reduction in the corporate income tax rate to 21% in 2018, 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.

28. The deduction for qualified business income is 20% of qualified business income (QBI).

General Rule

29. 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.

30. In general, the deduction for qualified business income is the lesser of:

    a. 20% of qualified business income (QBI), or

    b. 20% of modified taxable income.

31. 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.

The Overall Limitation: Modified Taxable Income

32. In all cases, the § 199A deduction may not exceed 20% of the taxpayer's modified taxable income.

33. Modified taxable income is taxable income before the deduction for qualified business income, reduced by any net capital gain.

Definition of Qualified Business Income

34. Qualified business income (QBI) 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).

35. Qualified business income does not include certain types of investment income, such as:
    - Capital gains or capital losses.
    - 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.

36. Although the statute is not clear, many practitioners believe that § 1231 transactions should be included in qualified business income. This (and other questions) will remain unresolved until the Treasury Department issues guidance.

Definition of a Qualified Trade or Business

37. For taxpayers who fall below critical taxable income thresholds established under § 199A ($315,000 for married taxpayers filing jointly; $157,500 for all other taxpayers), the scope of a qualified trade or business (QTB) is broad.

    a. In general, it includes any trade or business other than providing services as an employee.

    b. As a result, the deduction is available to sole proprietors, independent contractors, and noncorporate owners of S corporations, partnerships, and LLCs.

38. Taxpayers with Multiple Businesses. The deduction for qualified business income must be determined separately for each qualified trade or business and then combined. This combined amount is then compared to the overall modified taxable income limit.

Limitations on the QBI Deduction

39. Once the taxable income thresholds—$315,000 for married taxpayers filing jointly and $157,500 for all other taxpayers—are reached, § 199A imposes two independent limitations:

    a. 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.

    b. 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.

40. 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).

41. Concept Summary 2.2 in the text provides a flowchart to assist in applying these rules.

Limitation Based on Wages and Capital Investment

42. The W–2 Wages/Capital Investment Limit limits the 20% QBI deduction to the greater of:

a. 50% of the "W−2 wages" paid by the QTB.

b. 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.

43. 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.)

44. W−2 Wages/Capital Investment Limit.

a. 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."

b. Given the broad-based changes to MACRS made by the TCJA of 2017—allowing taxpayers to expense (via § 179 and/or bonus depreciation) property other than real estate—the "depreciable period" for "qualified property" under § 199A is a minimum of 10 years. (See Example 15 in the text.)

c. 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.)

45. Phase-In of W−2 Wages/Capital Investment Limit.

a. The W−2 Wages/Capital Investment Limit does not apply to taxpayers with taxable income before the QBI deduction less than the threshold amount ($315,000 for married taxpayers filing jointly; $157,500 for all others).

b. 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.

c. 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:

(1) Determine difference between the general 20% QBI deduction amount and the W−2 Wages/Capital Investment amount.

(2) Determine the Reduction Ratio.

(3) Determine the Reduction in the W−2 Wages/Capital Investment Limit.

(4) Determine QBI amount.

d. See Example 17 in the text for an illustration of these calculations.

Limitation for "Specified Services" Businesses

46. For high-income taxpayers, § 199A excludes any "specified service trade or business" from the definition of a qualified trade or business.

47. 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.

48. Architects and engineers are specifically excluded from this definition.

49. According to the legislative history of the TCJA of 2017, 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."

50. 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.

51. Phase-In of the "Specified Services" Limit.

a. 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 19 in the text.)

b. 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 20 in the text.)

c. Compare Examples 20 and 22 in the text to demonstrate the implications (and disadvantages) of having a "specified services" business.

d. An even more complex setting is having multiple businesses—some "specified services" and others not. (See Example 23 in the text.)

Treatment of Losses

52. 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).

53. 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 24 in the text.)

Coordination with Other Rules

54. The deduction for qualified business income operates along with other rules (e.g., how to determine business income).

55. The QBI deduction does not reduce the tax bases for self-employment taxes or the net investment income tax (NIIT).

56. 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.

Considerations for Partnerships and S Corporations

57. The deduction for qualified business income applies to taxpayers other than corporations. The QBI deduction is available to individuals, trusts, and estates.

58. Although the earlier examples involved sole proprietors, the same result would occur if the business income was instead generated by a partnership or S corporation. (See Example 25 in the text.)

59. Partnerships and S corporations might use a tax year other than a calendar year. (See Example 26 in the text.)

Open Issues

60. Guidance from the Treasury Department is needed to resolve interpretive questions, including the following:

a. What businesses are considered "specified service trades or businesses"?

b. How is the wage limit applied if a business uses a professional employer organization (PEO) to manage its workforce?

c. Are capital gains and losses from the disposition of business assets included in the term *qualified business income*?

d. When can an individual's trades or businesses be separated or combined?

e. If an individual has businesses in separate legal entities, is each a separate business or must they be combined?

f. When is rental real estate considered a qualified trade or business?

g. How are losses from one business netted against income from other businesses?

TAX PLANNING

Corporate versus Noncorporate Forms of Business Organization

61. The form of business organization affects the application of various tax rules including tax rates, deductions, tax accounting methods, and tax years.

62. The decision on what form to use can change as a business grows.

Optimizing the Deduction for Qualified Business Income

63. Some planning is possible to increase the deduction or perhaps to avoid losing the deduction.

64. As the Treasury Department releases guidance, some of these planning ideas might not be needed (or might not be allowed).

    a. For taxpayers with taxable income above the $157,500 threshold ($315,000 if married filing jointly), consider converting any contractor payments to employee wages to increase the 50% of W–2 wages limitation.

    b. 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.

    c. Depending on Treasury Department guidance, consider how businesses can be combined or separated, including perhaps placing one or more in separate legal entities, to increase the QBI deduction.

    d. Employees might consider whether they can become self-employed in their field (which would enable the QBI deduction).

THE BIG PICTURE

As Amy begins her career, the simplest entity to use is a sole proprietorship. If the risks for her business, such as injury to customers, are minimal, she will likely find that forming an LLC or a corporation to reduce her personal risk, is not warranted.

If, however, Amy wants a more formal structure or a legal structure to reduce her personal risk, an S corporation should work well as it allows her income and losses to flow through to her individual tax return. As her income grows, she might consider converting to a C corporation due to the 21% maximum rate, although she must also consider the effect of double taxation.

Amy must also consider the QBI deduction (assuming she does not operate as a C corporation) as well as state and local taxes.

RESEARCH PROBLEMS

Solutions to end-of-chapter Research Problems are located in the Solutions Manual.

CHAPTER

2

The Deduction for Qualified Business Income for Pass-Through Entities

Corporations, Partnerships, Estates & Trusts

SOUTH-WESTERN FEDERAL TAXATION

The Big Picture (slide 1 of 2)

- Amy plans to start at least two different business activities after she graduates from college
  - One business involves using various forms of social media to promote her skills and experience as a volleyball player to help younger players develop their skills
    - She plans to generate income from advertising on her social media sites
  - She also will use her artistic and marketing talents to find work using several web platforms, like Upwork and Freelancer

The Big Picture (slide 2 of 2)

- Amy is wondering if she should form a corporation or a limited liability company for these pursuits, or just be a sole proprietor
  - She is also curious whether, for tax and legal purposes, she has one business or two
- After reading this chapter, you can help Amy with her questions, including aiding her in better framing the questions should she decide to seek assistance from an attorney on business entity formation matters, or a CPA for tax and accounting assistance
- *Read the chapter and formulate your response*

Various Business Forms

- Business operations can be conducted in a number of different forms including
  - Sole proprietorships
  - Partnerships
  - Trusts and estates
  - S corporations (also called Subchapter S corps)
  - Regular corporations (also called C corps)
  - Limited liability companies

Sole Proprietorship

- Not a separate taxable entity
- Income reported on owner's Sch. C

The Big Picture – Example 1
Sole Proprietorships

- Return to the facts of The Big Picture on p. 2-1
- The easiest business entity for Amy to form is a sole proprietorship
  – No legal documents are needed for the proprietorship
    - She may need to obtain a business license and file a statement of business purpose
- She should also set up accounting records
  – This will make her accounting and tax recordkeeping simpler
  – She should have a separate bank account and credit card for business purposes

Partnership (slide 1 of 2)

- Separate entity, but does not pay tax
  - Files information return (Form 1065)
- Business income and expense items are aggregated in computing the ordinary business income (loss) of the partnership
- Certain income and expense items are reported separately to the partners
  - e.g., Interest and dividend income, long term capital gain, charitable contributions and investment expenses

Partnership (slide 2 of 2)

- Partnership ordinary business income (loss) and separately reported items are allocated to partners according to their profit and loss sharing ratios
  - Each partner receives a Schedule K–1
    - Reports partner's share of partnership ordinary business income (loss) and separately stated items
  - Each partner reports these items on his or her own tax return

S Corporation

- Separate entity, only pays special taxes (e.g., built-in gains)
  - Files information return Form 1120S
- Similar to partnership taxation
  - Ordinary business income (loss) flows through to the shareholders to be reported on their separate returns
  - Certain items flow through to the shareholders and retain their separate character when reported on the shareholders' returns
- The S corporation ordinary business income (loss) and the separately reported items are allocated to the shareholders according to their stock ownership interests

C Corporation

- C corporations are subject to an entity-level Federal income tax which results in what is known as a *double taxation* effect
  - C corporation reports its income and expenses and computes tax using a flat rate of 21% on the taxable income reported on its Form 1120
  - When corporation distributes its income, the corporation's shareholders report dividend income on their own tax returns
    - Thus, income that has already been taxed at the corporate level is also taxed at the shareholder level

Dividends

- Double taxation stems, in part, from the fact that dividend distributions are *not deductible* by the corporation
- To alleviate some of the double taxation effect, Congress reduced the tax rate applicable to dividend income of individuals
  - Qualified dividend income is taxed at a rate of 15% (20% for high-income taxpayers; 0%for lower-income taxpayers)
  - These rates also apply to long-term capital gains

Corporations vs 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, and
  - State taxes

Corporate Income Tax Rates
(slide 1 of 2)

- A flat rate of 21% applies to corporate taxable income for taxable years beginning after 2017
  - Historically, however, a graduated corporate tax rate structure has applied
- The marginal rates for individuals range from 10% to 37%
  - In many cases, taxes will be greater in the corporate form

Corporate Income Tax Rates

(slide 2 of 2)

EXHIBIT 2.1 Corporate Income Tax Rates for Taxable Years Beginning Before 2018

Taxable Income		Tax Is:	
Over—	But Not Over—		Of the Amount Over—
$ 0	$ 50,000	15%	$ 0
50,000	75,000	$ 7,500 + 25%	50,000
75,000	100,000	13,750 + 34%	75,000
100,000	335,000	22,250 + 39%	100,000
335,000	10,000,000	113,900 + 34%	335,000
10,000,000	15,000,000	3,400,000 + 35%	10,000,000
15,000,000	18,333,333	5,150,000 + 38%	15,000,000
18,333,333	—	35%	0

Nontax Issues in Selecting Entity Form (slide 1 of 3)

- Liability
  - Sole proprietors and some partners have *unlimited liability* for claims against the entity
- Capital-raising
  - Corporations and partnerships to a lesser extent can raise large amounts of capital for entity ventures

Nontax Issues in Selecting Entity Form (slide 2 of 3)

- Transferability
  - Corporate stock is easily sold, but partners must approve partnership interest transfer
- Continuity of life
  - Corporations exist indefinitely

Nontax Issues in Selecting Entity Form (slide 3 of 3)

- Centralized management
  - Corporate actions are governed by a board of directors
  - Partnership operations may be conducted by each partner without approval by other partners

Limited Liability Companies (LLC)

- LLCs have proliferated since 1988 when IRS ruled it would treat qualifying LLCs as partnerships
  - Major nontax advantage
    - Allows owners to avoid unlimited liability
  - Major tax advantage
    - Allows qualifying business to be treated as a proprietorship or partnership for tax purposes, thereby avoiding double taxation associated with C corporations

Entity Classification Prior to 1997 (slide 1 of 2)

- Sometimes difficult to determine if entity will be taxed as a corporation
  - If entity has a majority of corporate characteristics, it is taxed as a corporation
  - Most entities have the following characteristics:
    - Associates
    - Objective to carry on business and share profits

Entity Classification Prior to 1997 (slide 2 of 2)

- If entity has a majority of the following relevant corporate characteristics it is treated as a corporation:
  - Continuity of life
  - Centralized management
  - Limited liability to owners
  - Free transferability of ownership interests

Entity Classification After 1996 (slide 1 of 2)

- **Check-the-box Regulations**
  - Allows taxpayer to choose tax status of an unincorporated entity without regard to corporate or noncorporate characteristics
  - Entities with > 1 owner can elect to be classified as partnership or corporation
  - Entities with only 1 owner can elect to be classified as sole proprietorship or as corporation

Entity Classification After 1996 (slide 2 of 2)

- **Check-the-box Regulations (cont'd)**
  – If no election is made, multi-owner entities treated as partnerships, single person businesses treated as sole proprietorships
  – Election is not available to:
    - Entities incorporated under state law
    - Entities required to be corporations under federal law (e.g., certain publicly traded partnerships)

THE DEDUCTION FOR QUALIFIED BUSINESS INCOME (slide 1 of 2)

- Under the TCJA of 2017, § 199A, Qualified Business Income, was added to the Internal Revenue Code
  - Allows up to a 20% deduction on the qualified business income (QBI) of noncorporate taxpayers
  - This deduction is potentially available to individuals, trusts, and estates
    - Owners of partnerships and S corporations use relevant information provided to them from the entity (on their Schedule K-1 and related attachments) to calculate the deduction on their tax return

THE DEDUCTION FOR QUALIFIED BUSINESS INCOME (slide 2 of 2)

- Under the TCJA of 2017, the deduction for qualified business income is temporary
  - It is in effect from 2018 through 2025
- The balance of this chapter explains the deduction for qualified business income
  - This new deduction includes numerous definitions, limitations, and special rules
- Appreciating the purpose of the deduction—to reduce the tax on business income derived outside of the C corporate form—will help in understanding this provision

THE DEDUCTION FOR QBI – General Rule (slide 1 of 2)

- The deduction for qualified business income is 20% of **qualified business income** (QBI) generated through a sole proprietorship, a partnership, or an S corporation
- In general, the deduction for qualified business income is the lesser of:
  - 20% of qualified business income (QBI), or
  - 20% of modified taxable income
- Effectively, the QBI deduction—a *from* AGI deduction—is the last deduction taken in determining taxable income

THE DEDUCTION FOR QBI – General Rule (slide 2 of 2)

- 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
- The second and third limitations only apply when taxable income before the QBI deduction exceeds, in 2018,
  - $315,000 for married taxpayers filing a joint return, or
  - $157,500 for all other taxpayers

THE DEDUCTION FOR QBI – The Overall Limitation

- In all cases, the § 199A deduction may not exceed 20% of the taxpayer's *modified taxable income*
  - Modified taxable income is taxable income *before* the deduction for QBI, reduced by any *net capital gain*
    - Here, the term *net capital gain* includes both
      - A net capital gain
        - The excess of a long-term capital gain over a short-term capital loss (§ 1222), plus
      - Any qualified dividend income

THE DEDUCTION FOR QBI – Definition of Qualified Business Income

(slide 1 of 2)

- **Qualified business income** (QBI) 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
  - It also includes the distributive share of these amounts from each partnership or S corporation interest held by the taxpayer

THE DEDUCTION FOR QBI – Definition of Qualified Business Income
(slide 2 of 2)

- **Qualified business income** does not include certain types of investment income, such as:
  - Capital gains or capital losses;
  - Dividends;
  - Interest income (unless "properly allocable" to a trade or business, such as lending); or
  - 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, or
  - Guaranteed payments made to a partner for services rendered

THE DEDUCTION FOR QBI – Definition of a Qualified Trade or Business (slide 1 of 3)

- For taxpayers who fall below critical taxable income thresholds established under § 199A, the scope of a **qualified trade or business** (QTB) is broad
  - In general, it includes any trade or business other than providing services as an employee
  - Taxable income thresholds are
    - $315,000 for married taxpayers filing jointly
    - $157,500 for all other taxpayers

THE DEDUCTION FOR QBI – Definition of a Qualified Trade or Business (slide 2 of 3)

- As a result, the deduction is available to sole proprietors, independent contractors, and noncorporate owners of S corporations, partnerships, and LLCs
- High-income taxpayers who are engaged in businesses involving the performance of services in certain “specified” fields are subject to certain restrictions

THE DEDUCTION FOR QBI – Definition of a Qualified Trade or Business (slide 3 of 3)

- **Taxpayers with Multiple Businesses**
  - The deduction for qualified business income must be determined separately for each qualified trade or business
  - These independent calculations are then combined becoming the “qualified business income amount” identified in § 199A(a)(1)(A)
  - This combined amount is then compared to the overall modified taxable income limit

THE DEDUCTION FOR QBI – Limitations on the QBI Deduction

(slide 1 of 11)

- Once the taxable income thresholds are reached, § 199A imposes two *independent* limitations
  - One limitation is based on wages and capital investment
  - The second limitation applies to income earned from "specified service" businesses including
    - Doctors
    - Dentists
    - Lawyers
    - Accountants
    - Consultants
    - Investment advisers
    - Entertainers, and
    - Athletes
  - Engineers and architects are not subject to this limitation

THE DEDUCTION FOR QBI
– Limitations on the QBI Deduction
(slide 2 of 11)

- These taxable income thresholds—determined without regard to the QBI deduction—are
  - $315,000 for married taxpayers filing jointly, and
  - $157,500 for all other taxpayers
  - These amounts will be indexed for inflation after 2018

THE DEDUCTION FOR QBI – Limitations on the QBI Deduction
(slide 3 of 11)

- These limitations are fully phased in once taxable income (before the QBI deduction) exceeds
  - $415,000 for married taxpayers filing jointly, and
  - $207,500 for all other taxpayers
- Within the phase-in ranges, the limitations are each applied by comparing the amount of taxable income that exceeds the threshold amount to the appropriate phase-in range
  - Phase-in ranges are $100,000 for married taxpayers filing jointly; $50,000 for all other taxpayers

THE DEDUCTION FOR QBI – Limitations on the QBI Deduction
(slide 4 of 11)

Limitation Based on Wages & Capital Investment

- Limits the 20% QBI deduction to the *greater of*:
  – 50% of the "W−2 wages" paid by the QTB, or
  – 25% of the "W−2 wages" paid by the QTB *plus* 2.5% of the taxpayer's share of the unadjusted basis of "qualifying property"
- Phased in as a taxpayer's income exceeds the taxable income thresholds

THE DEDUCTION FOR QBI
– Limitations on the QBI Deduction
(slide 5 of 11)

Limitation Based on Wages & Capital Investment

- “W−2 wages” includes
  - Total amount of wages subject to income tax withholding,
  - Compensation paid into qualified retirement accounts, and
  - Certain other forms of deferred compensation

THE DEDUCTION FOR QBI
– Limitations on the QBI Deduction
(slide 6 of 11)

W−2 Wages/Capital Investment Limit

- 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 DEDUCTION FOR QBI – Limitations on the QBI Deduction

(slide 7 of 11)

Phase-In of Wages/Capital Investment Limit

- If taxable income before the QBI deduction is
  - ***Less than*** the threshold amounts
    - This limit does not apply
  - **More than** the threshold amounts
    - The W–2 Wages/Capital Investment Limit must be used

THE DEDUCTION FOR QBI
– Limitations on the QBI Deduction
(slide 8 of 11)

Phase-In of Wages/Capital Investment Limit

- If 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:
  - 1. Determine difference between the general 20% QBI deduction amount and the W–2 Wages/Capital Investment amount

THE DEDUCTION FOR QBI
– Limitations on the QBI Deduction
(slide 9 of 11)

Phase-In of Wages/Capital Investment Limit

– 2. Determine the Reduction Ratio

$$\text{Reduction Ratio} = \frac{\text{Taxable income before the QBI deduction} - \text{Threshold amount}}{\$100{,}000 \text{ (married filing jointly); } \$50{,}000 \text{ (others)}}$$

– 3. Determine the Reduction in the W–2 Wages/Capital Investment Limit:

- Reduction = Difference [from (1)] X Reduction ratio [from (2)]

– 4. Determine QBI amount:

- 20% QBI deduction - Reduction [from (3)]

THE DEDUCTION FOR QBI
– Limitations on the QBI Deduction
(slide 10 of 11)

Limitation for "Specified Services" Businesses

- For high-income taxpayers, § 199A excludes any "specified service trade or business" from the definition of a qualified trade or business including those involving:
  - Health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services; investing and investment management, trading or dealing in securities, partnership interests, or commodities; and
  - Any trade or business where the business's principal asset is the reputation of one or more of its employees or owners
- Architects and engineers are specifically excluded from this definition

THE DEDUCTION FOR QBI – Limitations on the QBI Deduction

(slide 11 of 11)

Phase-In of the Specified Services Limit

- 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

$$\text{Applicable percentage} = 100\% - \frac{\text{Taxable income before the QBI deduction} - \text{Threshold amount}}{\$100{,}000 \text{ (married filing jointly); } \$50{,}000 \text{ (others)}}$$

THE DEDUCTION FOR QBI – Treatment of Losses

- If a taxpayer has a qualified business loss in one year, no QBI deduction is allowed
  - The loss is carried over to the next year to reduce QBI (but not below zero)
  - Further, 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

THE DEDUCTION FOR QBI – Coordination with Other Rules

- The QBI deduction is allowed only for *income* taxes
  - As a result, the QBI deduction does not reduce the tax bases for self-employment taxes or the net investment income tax (NIIT)
- Also, 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

Refocus On The Big Picture
(slide 1 of 5)

- The simplest entity for Amy to use is a sole proprietorship
  - If she generates losses, they can be used to offset other income she might have
  - For example, if she also takes on a part-time job until her businesses generate sufficient income to enable Amy to support herself

Refocus On The Big Picture
(slide 2 of 5)

- If the risks for her business, such as injury to customers, are minimal, she will likely find that forming an LLC or a corporation to reduce her personal risk, is not warranted
  - The additional formation costs, continuing fees, and possible business taxes she might owe in her state of residence can be avoided, and
  - Amy can purchase insurance to reduce the costs of any personal risk

Refocus On The Big Picture
(slide 3 of 5)

- If Amy wants a more formal structure or a legal structure to reduce her personal risk, an S corporation should work well as it allows her income and losses to flow through to her individual tax return
  - As Amy's income grows, she might consider converting to a C corporation due to the 21 percent maximum rate, although she must also consider the effect of double taxation

Refocus On The Big Picture

(slide 4 of 5)

- Amy must also consider the QBI deduction (assuming she does not operate as a C corporation)
  - Until her income reaches the thresholds for the specified service trade or business, she should obtain a deduction even though both of her pursuits might be a “specified services” business
    - i.e., consulting or where the principal business asset is Amy’s reputation or skill

Refocus On The Big Picture
(slide 5 of 5)

- Finally, Amy should consider state and local taxes
  - She will need to check these laws to determine, for example, if a business license tax is owed at the local level and if she is considered to have one business or two

If you have any comments or suggestions concerning this PowerPoint Presentation for South-Western Federal Taxation, please contact:

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