Today’s speakers

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Senior Manager
Compensation & Benefits team leader

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Senior Manager
Pass-through tax consulting team leader
Agenda

- A brief review of the section 199A deduction
- Reevaluating compensation paid to owners for services and capital
- Understanding the impact of section 199A on common retirement strategies for owners of closely held businesses
- Reviewing compensation methods of non-owners
- Latest developments on profits interests, including interests issued to full-time employees
A BRIEF REVIEW OF SECTION 199A – THE PASS-THROUGH DEDUCTION
The section 199A deduction

• A 20% deduction that effectively reduces the top rate on certain business income from 37% to 29.6%
• Limitations apply to taxpayers with taxable income in excess of thresholds
  - ‘Specified service’ businesses become ineligible
  - Additional limitations based on wages paid or tangible assets
• Only applies to income taxes (not self employment or net investment income tax)
Who is eligible for the section 199A deduction?

- Individuals and trusts with qualifying income from:
  - Sole proprietorships (Schedule C)
  - Rental businesses (Schedule E)
  - Farming businesses (Schedule F)
  - S corporations
  - Partnerships (including PTPs)
  - Trusts and estates (K-1 income)
  - REITs (real estate investment trusts)
  - Qualified cooperatives

- C corporations are NOT eligible for the deduction
Wage and asset limits

• Applies to taxpayers with taxable income
  < $157,500 single
  < $315,000 joint

• Pass-through deduction limited to the owner’s share of the greater of:
  - 50% of W-2 wages (employees and owners), or
  - 2.5% of original cost of depreciable, tangible property plus 25% of wages
Section 199A deduction

- Does not apply to:
  - Investment income
  - Foreign source income
  - Wages paid to shareholders
  - Guaranteed payments for services
  - Guaranteed payments for the use of capital
  - Capital gain from the sale of business assets
How do wages impact the section 199A deduction?

- Wages paid to employees, including owner-employees, are included in the wage limit
- Wages income is not eligible for the deduction
- Additional wages paid to owner-employees could either increase or decrease the section 199A deduction
Owner wages may increase or decrease ordinary income

<table>
<thead>
<tr>
<th></th>
<th>No owner wages</th>
<th>$100,000 of owner wages</th>
<th>$300,000 of owner wages</th>
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</thead>
<tbody>
<tr>
<td>Wage income</td>
<td>$0</td>
<td>$100,000</td>
<td>$300,000</td>
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<tr>
<td>Qualified business income (QBI)</td>
<td>$1,000,000</td>
<td>$900,000</td>
<td>$700,000</td>
</tr>
<tr>
<td>Wages paid by S corporation for section 199A</td>
<td>$300,000</td>
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<td>$600,000</td>
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<tr>
<td>199A deduction - Lesser of 20% of QBI or 50% of wages</td>
<td>($150,000)</td>
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<td>Taxable ordinary income</td>
<td>$850,000</td>
<td>$820,000</td>
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</table>

- **S corporation with single owner**
- **Pays employee wages of $300,000**
- **$1,000,000 of income prior to payment of owner’s wages**
How do guaranteed payments impact the section 199A deduction?

- Guaranteed payments are not included in the wage limit
- Guaranteed payment income is not eligible for the deduction
- Increases to guaranteed payments will generally decrease the section 199A deduction
- Partnerships are not generally subject to the same reasonable compensation standards that apply to S corporations
Guaranteed payments do not impact wage base

<table>
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<tr>
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<tr>
<td>Guaranteed payment income</td>
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- Partner’s allocated share of employee wages is $300,000
- $1,000,000 of income prior to payment of guaranteed payments
Reductions to guaranteed payments may increase the section 199A deduction

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- Partner’s allocated share of employee wages is $500,000
- $1,000,000 of income prior to payment of guaranteed payments

199A deduction = lesser of 20% of QBI or 50% of wages

Taxable ordinary income = No guaranteed payments + 199A deduction
RETIREMENT PLANNING AND SECTION 199A
Payments to qualified plans can increase wage base

- Contributions to qualified plans may generate deductions greater than the amounts contributed

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<td>$770,000</td>
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Owner contributions to qualified retirement plans

• Consider rate and timing difference between deduction and income
  - Current deduction and future income is a deferral of tax
  - The time and rate differences in those will change the math

• Contributions are limited by qualified retirement plan rules
  - Subject to testing in the overall plan
  - Limitations based on annual limits and SE income of partners
Payments to qualified plans can reduce impact of income phase-out

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<td>Phase-in of wage limit</td>
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• Wage limits phase in between $315,000 and $415,000 for married taxpayers

• Many deductions, including deductible contributions to qualified plans, can create high marginal benefits
PAYMENTS TO OWNERS FOR USE OF CAPITAL
Payments to owners for capital

• Payments of interest and guaranteed payments for use of capital are not qualifying income for section 199A

• In addition, these items may create nondeductible expenses due to new limits on interest expense under 163(j)
PAYMENTS TO SERVICE PROVIDERS
Employee vs. independent contractor

- Payments to independent contractors are not included as wages in the wage test

- Recipients of 1099s may be themselves be eligible for the section 199A deduction
ISSUING PROFITS INTERESTS TO EMPLOYEES
Issuing profits interests to employees

• The IRS has generally held, and has recently reiterated its position that partners cannot be employees of the same taxable entity – including “disregarded entities”

• Questions exist whether W-2s issued to these individuals are valid for section 199A wage test purposes
Thank you
THANK YOU FOR YOUR TIME AND ATTENTION