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Qualified Business Income Deduction- New Proposed Regulations, Part II

by Robert P. Achenbach, Jr.*

In the last issue of the *Digest*, the basic provisions of the qualified business income deduction (QBI deduction) were discussed. In this issue are discussed the provisions governing the W-2 wage limitations.

The W-2 Wage Limitations

The maximum QBI deduction is limited to 20 percent of QBI. For taxpayers with QBI above \$157,500 (\$315,000 for joint filers),¹ the deduction is further limited (up to 20 percent of QBI) to the greater of (1) 50 percent of the W-2 wages with respect to the qualified trade or business; or (2) 25 percent of the W-2 wages with respect to the qualified trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property.² The wage limit is phased in for taxpayers with taxable income that is more than the threshold amount but less than the threshold amount plus \$50,000 (\$100,000 for joint filers).³ The wage limit applies fully for a taxpayer with taxable income that exceeds the threshold amount plus \$50,000 (\$100,000 for joint filers).

Definition of W-2 Wages

The term "W-2 wages" means the total wages subject to wage withholding, elective deferrals,⁴ and deferred compensation paid by the qualified trade or business to employment its employees during the calendar year ending during the taxpayer's tax year.⁵

W-2 wages do not include (1) any amount that is not properly allocable to qualified business income or (2) any amount that is not properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for such return.⁶

W-2 wages are to be determined in three steps (1) determination of total W-2 wages,⁷ (2) allocation of the wages to each trade or business,⁸ and (3) determination of which wages for each business are allocable to the QBI for each business.⁹

Definition of Qualified Property

Qualified property is defined in general as tangible depreciable property under IRC § 167 (1) held at the end of the tax year, (2) used for the production of income in the trade or business during the tax year, and (3) had not been completely depreciated by the end of the tax year.¹⁰

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The depreciable period with respect to qualified property of a taxpayer means the period beginning on the date the property is first placed in service by the taxpayer and ending on the later of the date that is 10 years after that date or the last day of the last full year in the applicable recovery period that would apply to the property under I.R.C. § 168 (without regard to Section 168(g)).¹¹

The additional first-year depreciation deduction allowable under I.R.C. § 168 does not affect the applicable recovery period under this paragraph for the qualified property.¹²

The date on which the replacement MACRS property was first placed in service is determined as follows—

(1) Except as provided in paragraph (3) below, the date the exchanged basis in the replacement MACRS property was first placed in service by the trade or business is the date on which the relinquished property was first placed in service;

(2) Except as provided in paragraph (3) below, the date the excess basis in the replacement MACRS property was first placed in service is the date on which the replacement MACRS property was first placed in service; or

(3) If the taxpayer or pass-through entity makes an election not to apply Treas. Reg. § 1.168(i)-6, the date the exchanged basis and excess basis in the replacement MACRS property was first placed in service by the trade or business is the date on which the replacement MACRS property was first placed in service.¹³

Basis of Qualified Property

For purposes of the W-2 wage/qualified property limit, the basis of depreciable property is its unadjusted basis immediately after acquisition.¹⁴ Depreciation deductions do not reduce this basis.¹⁵ The proposed regulations identify treatments of various depreciation situations:

- Additions or improvements of qualified property that has already been placed in service are treated as separate qualified property first placed in service on the date the addition or improvement is placed in service.¹⁶

- Basis adjustments under I.R.C. §§ 734(b) and 743(b) are not treated as qualified property.¹⁷

- Qualified property does not include property acquired within 60 days of the end of the taxable year and disposed of within 120 days without having been used in a trade or business for at least 45 days prior to disposition, unless the taxpayer demonstrates that the principal purpose of the acquisition and disposition was a purpose other than increasing the QBI deduction.¹⁸ The regulations do not provide any guidance for determining “principal purpose.”

Phase-in of W-2 Wage Limit

For a taxpayer with taxable income within the phase-in range, the wage limit applies as follows: With respect to any qualified trade or business, the taxpayer compares (1) 20 percent of the taxpayer’s qualified business income from the qualified trade or business with (2) the greater of 50 percent of the W-2 wages with respect to the qualified trade or business or 25 percent of the W-2 wages with respect to the qualified trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property. If the amount determined under (2) is

less than the amount determined under (1) (that is, if the wage limit is binding), the taxpayer’s deductible amount is the amount determined under (1) reduced by the same proportion of the difference between the two amounts as the excess of the taxable income of the taxpayer over the threshold amount bears to \$50,000 (\$100,000 MFJ).¹⁹

Example: A single taxpayer has business income from a small fruit packing company with QBI of \$160,000. The QBI deduction for that amount is (\$160,000 x .20 = \$32,000). The business paid \$20,000 in W-2 wages. The difference between the QBI deduction and the wage limitation is \$12,000. The W-2 wage limitation is reduced by the ratio of actual QBI (\$160,000) less the QBI income limit (\$157,500) over 50,000 ((160,000-157,500)/50,000 = .05). Thus, the QBI deduction is calculated by reducing the \$12,000 by the phase-in ratio: (.05 x \$12,000 = \$600) and subtracting the reduction from the QBI deduction (32,000 - \$600 = \$31,400).

ENDNOTES

¹ The threshold is indexed for inflation for tax years beginning after 2018. Prop. Treas. Reg. § 1.199A-1(b)(11).

² Pub. L. No. 115-97, § 11011, 131 Stat. 2063 (2017), adding I.R.C. § 199A(b). See Prop. Treas. Reg. § 1.199A-2. Note that the wage limitation does not apply to specified service trade or businesses because they are not eligible for the QBI deduction above the income limits.

³ Prop. Treas. Reg. § 1.199A-1(b)(8) (reduction amount).

⁴ See I.R.C. § 402(g)(3)

⁵ Prop. Treas. Reg. § 1.199A-1(b)(15). Deferred compensation includes compensation deferred under I.R.C. § 457, and the amount of any designated Roth contributions, as defined in I.R.C. § 402A.

⁶ See Prop. Treas. Reg. § 1.199A-2(b)(2)(iii).

⁷ Prop. Treas. Reg. § 1.199A-2(b)(2).

⁸ Prop. Treas. Reg. § 1.199A-2(b)(3) (the portion of the W-2 wages allocable to each trade or business is determined in the same manner as the expenses associated with those wages are allocated among the trades or businesses).

⁹ Prop. Treas. Reg. § 1.199A-2(b)(4) (W-2 wages are properly allocable to QBI if the associated wage expense is taken into account in computing QBI under Prop. Treas. Reg. § 1.199A-3.).

¹⁰ Pub. L. No. 115-97, § 11011, 131 Stat. 2063 (2017), adding I.R.C. § 199A(b). Prop. Treas. Reg. § 1.199A-2(c).

¹¹ *Id.* See Prop. Treas. Reg. § 1.199A-2(c)(2).

¹² Prop. Treas. Reg. § 1.199A-2(c)(2)(ii).

¹³ Prop. Treas. Reg. § 1.199A-2(c)(2)(iii).

¹⁴ Prop. Treas. Reg. § 1.199A-2(c)(1)(iv)(B)(3).

¹⁵ *Id.*

¹⁶ Prop. Treas. Reg. § 1.199A-2(c)(1)(ii).

¹⁷ Prop. Treas. Reg. § 1.199A-2(c)(1)(iii).

¹⁸ Prop. Treas. Reg. § 1.199A-2(c)(1)(iv).

¹⁹ Prop. Treas. Reg. § 1.199A-1(d)(2)(iv)(A)(2). See Prop. Treas. Reg. § 1.199A-1(d)(2)(iv)(A)(2), example 2.