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Not Everyone Gets the 199A Pass-through Deduction

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When Congress created the Section 199A Pass-through Deduction, they made it about as easy as making a Soufflé. One misstep and your deduction goes from great to flat. But some businesses are given the black-white cross flag right at the starting line because they are disqualified to begin with.

There has been a lot of press from various members of the government establishment on how this deduction is going to be great for small businesses and reduce taxes. What they fail to highlight is your business has to meet the definition of a "qualifying business" before you begin.

THE ANSWER IS ZERO

First there is the obvious. If you don't have a pass-through, you don't get the deduction. So sorry C Corporations, you received the reduced tax rate instead. Basically any entity that is **not** a partnership, S Corporation, or a sole-proprietorship can stop reading any further. You don't get it.

Some activities were also specifically excluded from qualifying under the law. Employees are not considered to be a business. And nope, if you were formally an employee of a business, you cannot suddenly decide to become self-employed and work for the same business in the same position as before to take advantage of the deduction. Tax exempts are not considered to be a business either, so no offsetting of the UBIT is allowed.

Also certain types of income are not to be treated as a trade or business. These include capital gains, dividends, non-business interest, gains from foreign currency transactions, non-business annuities, and a few other sources. And foreign income? Nope, this is domestic only.

Unfortunately from there things aren't so black and white.

CAUTION FLAG AHEAD

The new law uses the term trade or business. While it tries to use Code Section 162 as a guide, this has never been clearly defined by either the law or the courts and is largely a facts and circumstances determination. The difficulty of this situation is clearly highlighted in the area of rental real estate. In some cases the rental will qualify but in a lot of others it will not. The IRS has released Proposed Regulations specifically for this area, which we will cover in another blog post.

One item to note is that the law refers to trade or business, not entity. Each entity may need to split its activities into multiple trades or businesses, some of which may not qualify for the deduction and will need to be excluded.

AVOIDING A PILE UP

As was discussed in a **previous post**, a new category called Specified Service Trade or Business (SSTB) was created to prevent certain personal services businesses from taking advantage of the deduction. But not all SSTBs are disqualified.

Only those owned by individuals who make above certain income thresholds are, while others may be subject to a complicated calculation to limit their deduction.

Congress also created a special category for cooperatives, limiting the deduction to those agricultural or horticultural co-op businesses involved in certain creation, marketing or supplying activities.

There are numerous other red flags contained in the law and the qualifying rules are difficult enough such that you should consider consulting your tax advisor before attempting to cross the finish line under the checkered flag. Like in the big race, the penalties for violating these rules can get quite expensive.

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Victoria has over 25 years of experience in providing tax consulting, compliance and tax audit representation to closely held businesses and the owners of closely held businesses. She delivers a full range of tax services in covering federal and multi-state laws and regulations for partnerships, S and C corporations, and individuals.