

Davis Brown Tax Law Blog

Overview of Limitations to QBI Deductions Under IRC Section 199A – September 12, 2018

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Under the newly enacted Internal Revenue Code Section 199A, owners of pass-through entities, such as LLCs, partnerships, trusts, sole proprietorships, and S corporations, may deduct up to 20% of their qualified business income (QBI). While this deduction will be advantageous to qualifying business owners as a mechanism to reduce the amount of taxable income attributable to their business, the IRS has imposed limitations on the amount of this deduction.

As a preliminary matter, the QBI deduction is available without limitation to taxpayers whose incomes are under the threshold amount of \$315,000 for joint returns and \$147,500 for all other returns. However, for taxpayers whose incomes exceed the threshold amount, the QBI deduction is subject to certain limitations. If your business is over the threshold amount and within the phase-in range¹, a limit may be imposed on your 199A deduction based on the greater of either (1) the amount of W-2 wages paid by the business, or (2) the unadjusted basis immediately after acquisition (UBIA) of qualified property used in the business.

This post provides an overview of the methods for calculating W-2 wages and the UBIA of qualified property for purposes of the QBI deduction limitation.

Calculating W-2 Wages Paid by the Business

In calculating the QBI deduction, businesses can only deduct W-2 wages which are considered qualified business income. [As previously discussed](#), QBI is the net amount of your trade or business's income, gain, deduction, and loss calculated using only items included in your taxable income.

The IRS has set forth three methods to calculate W-2 wages, based on reference to the Box numbers which appear on the [Form W-2](#). The first method simplifies the calculation, while the second and third methods provide greater accuracy.

1. Unmodified Box Method

Under the Unmodified Box Method, the W-2 wages are calculated by taking the lesser of:

1. The total entries in Box 1 (wages, tips, and other compensation) of all Forms W-2 filed with the Social Security Administration ("SSA") by you with respect to your business's employees; or

2. The total entries in Box 5² (Medicare wages and tips) off all Forms W-2 filed with the SSA by you with respect to your business's employees.

2. Modified Box 1 Method

Under the Modified Box 1 Method, the W-2 wages are calculated as follows:

1. First, total the amounts in Box 1 (wages, tips, and other compensation) of all Forms W-2 filed with the SSA by you with respect to your business's employees;
2. Next, subtract from that total the amounts included in Box 1 of all Forms W-2 that are **not** wages for purposes of federal income tax withholding (e.g. supplemental unemployment compensation benefits);
3. Finally, add the total amounts that are reported in Box 12 (status codes to determine if the amount is income) of all Forms W-2 with respect to your business's employees that are properly coded D, E, F, G, and S.³

3. Tracking Wages Method

Under the Tracking Wages Method, you actually track the total wages subject to federal income tax withholding and make appropriate modifications. Using this method, the W-2 wages are calculated as follows:

1. Total the amounts of wages subject to federal income tax withholding that are paid to your business's employees and that are reported on Forms W-2 filed with the SSA for the calendar year; and
2. Add the total of the amounts that are reported in Box 12 (status codes to determine if the amount is income) of Forms W-2 filed with the SSA for the calendar year with respect to your employees that are properly coded D, E, F, G, and S.

The W-2 wages limitation set forth in the proposed QBI deduction applies separately for each trade or business, meaning W-2 wages which are allocable to multiple businesses or trades must be determined in proportion to the W-2 wages allocable to each particular trade or business. One method to reduce the impact of this W-2 wages limitation is to aggregate separate trades or businesses for the purpose of calculating QBI, associated W-2 wages, and other tax attributed used in calculating the QBI deduction (QBI aggregation). The process for QBI aggregation will be discussed in detail in an upcoming post.

Calculating UBIA of Qualified Property Used by the Business

Next, to determine your QBI deduction, you must also calculate the unadjusted basis immediately after acquisition of qualified property used in the business (UBIA of qualified property). The process for determining the UBIA of qualified property varies depending upon a number of factors such as the type of entity, the method by which property was acquired, and more. Future posts will examine these calculations in detail, however this post provides a brief introduction to this calculation.

General Definition of UBIA of Qualified Property

"Basis" can be summarized as the amount paid for an asset plus adjustments. The term unadjusted basis immediately after acquisition, or UBIA, generally means the basis on the placed in service date of the property, without regarding to any adjustments. However, UBIA **does** reflect a basis reduction for the percentage of the relevant passthrough entity's use of the property for the taxable year other than in the trade or business. As such, the UBIA of qualified property will generally be its cost under 26 C.F.R. 1012 (Basis of property—cost) as of the date

the property is placed in service. This commentary provides an introduction into calculating the UBIA of qualified property, however, there are a number of factors you should discuss with an attorney in order to properly calculate.

Effect of the 199A Deduction Limitation

The QBI deduction is limited to the lesser of:

1. 20% of your business's or trade's QBI, or
2. the greater of
 1. 50% of the W-2 wages, as calculated herein, or
 2. the sum of 25% of the W-2 wages, plus 2.5% of the UBIA of qualified property.

As such, to properly determine the deduction limitation, you must first determine the W-2 wages and UBIA of qualified property as outlined in this post. Next, compare these amounts to your business's QBI for each trade or business. Finally, you must compare 20% of the QBI to the W-2 wages limit and the UBIA of qualified property limit. If the amount of 20% of your QBI is greater than the amounts for the W-2 wage or UBIA of qualified property limitations, then the QBI component is limited to the W-2 or UBIA limitation. And remember, to reduce the impact of the W-2 wages limitation and thereby increase your 199A deduction, you may consider implementing the QBI aggregation method discussed above.

Taxpayers hoping to benefit from the 199A deduction should keep these limitations in mind when determining the potential amount of their deduction. Further, while the QBI deduction may prove advantageous for qualifying business owners, the proposed 199A regulations include anti-abuse safeguards to prevent improper tax avoidance schemes. If these calculations seem daunting, you can be reassured that the IRS is likely to issue additional guidance, instructions, and forms to assist with implementing this new deduction in the months to come. Keep up to date with the Davis Brown Law Firm Tax Blog for additional content and analysis regarding the QBI deduction and other developments in tax law. You should contact your attorney to determine how to best benefit from the QBI deduction while remaining within the bounds of the law.

[1] \$315,000–\$415,000 for joint filers; \$157,500–\$207,500 for all other taxpayers.

[2] For most people, Box 1 and Box 5 will be the same amount. However, Box 5 indicates the wages which are subject to Medicare taxes. There is no cap for Medicare taxes and Medicare taxes generally do not include pre-tax deductions. As such, the amount in Box 5 may be larger than the amount in Box 1, which shows the amount of wages which are subject to federal income tax.

[3] W-2 Box 12 Codes: D — Elective deferral under a 401(k) cash or arrangement plan. This includes a SIMPLE 401(k) arrangement; E — Elective deferrals under a Section 403(b) salary reduction agreement; F — Elective deferrals under a Section 408(k)(6) salary reduction SEP; G — Elective deferrals and employer contributions (including nonelective deferrals) to a Section 457(b) deferred compensation plan; and S — Employee salary reduction contributions under a Section 408(p) SIMPLE.

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