S-CORP

Defending America's Individually & Family Owned Businesses

COVID, Domestic Investment, and Section 199A Losses

Section 199A(c)(2) prevents a pass-through business from claiming the 199A deduction until it recoups its business losses from prior years ("199A Deficits"). For many family businesses that survived COVID, they are now being penalized when they again realize taxable profits due to the 199A Deficit rule.

<u>Problem</u>: Many family businesses incurred operating losses during the COVID pandemic. These COVID losses, combined with domestic capital investments qualifying for bonus depreciation, led to significant Section 199A deficits.

Paired with the fact that foreign source income earned by the business does not qualify as Qualified Business Income ("QBI") under Section 199A, the result is many family business owners still are unable to benefit from Section 199A, years after the pandemic ended.

This mismatch is exacerbated if the family made significant investments that qualify for bonus depreciation during this period. Their access to 199A is blocked, resulting in higher taxes that hinder their ability to recover, grow, invest and create jobs. As a final challenge, 199A Deficits cannot be offset by foreign income or gains triggered by the sale of business assets.

		COVID/Depreciation Losses		Recovery	
	Year 1	Year 2	Year 3	Year 4	Year 5
Qualified Business Income/Loss	$10,000,000	($10,000,000)	($1,500,000)	$5,000,000	$5,000,000
Foreign Income/Loss	$5,000,000	$5,000,000	$6,500,000	$6,500,000	$6,500,000
Total Income (A)	**$15,000,000**	**($5,000,000)**	**$5,000,000**	**$11,500,000**	**$11,500,000**
Net Operating Loss Deduction (B)			($5,000,000)	$0	$0
Section 199A Deficit		($10,000,000)	($11,500,000)	($6,500,000)	($1,500,000)
Section 199A Deduction (C)	$2,000,000	$0	$0	$0	$700,000
Taxable Income (A-B-C)	$13,000,000	($5,000,000)	$0	$11,500,000	$10,800,000
Federal Tax @ 37%	$4,810,000	$0	$0	$4,255,000	$3,996,000
Effective Federal Tax Rate	32%	0%	0%	37%	35%

This outcome contrasts with large C corporations that have unlimited ability to access their lower, 21-percent corporate rate and do not apply a higher tax rate to their foreign source income.

<u>Solution:</u> To address this imbalance, the S Corporation Association recommends extending disaster relief to pass-through businesses that survived the pandemic by allowing them to make a one-time election to zero out their Section 199A Deficit balances and immediately access the Section 199A deduction, just as Congress intended.

In addition, S-Corp has also long advocated that foreign income earned by pass-through businesses should be included in QBI. There is simply no reason to exclude this income from the deduction. Including foreign income would help address the challenge described above by allowing family businesses increased opportunities to offset their 199A Deficits and access the Section 199A deduction more rapidly.