The business income deduction: Do you qualify for the 20 percent tax break on your business income?

Michael G. Riley | Monday, August 20, 2018

Do You Qualify for the 20 percent Tax Break on Your Business Income?

The Basics of Calculating the IRC Section 199A Qualified Business Income Deduction

The deduction is available for any taxpayer other than a C corporation, so it is available to individuals who earn their business income as sole proprietors or who receive their business income through pass-through entities such as S corporations, partnerships, or limited liability companies. This is why the Section 199A deduction is sometimes called the “pass-through” business income deduction.

What follows is a general explanation of how the deduction is calculated to give you an introduction to the topic. Please be aware this summary does not describe all the rules that may apply to your particular situation. Some of those rules are described in related postings, but no general discussion can tell you how to maximize your deduction. The circumstances of your particular business need to be separately analyzed to determine whether and to what extent you may be able to deduct a portion of your business income. Happily, in many cases the answer will be “yes.”

HERE'S HOW THE BASIC CALCULATION WORKS

- The deduction allowed is 20 percent of "qualified business income" (see below) with respect to your "qualified trade or businesses" (see below), but not more than:
  - 50 percent of the W-2 wages of the trade or business, or if greater,
  - 25 percent of W-2 wages of the trade or business, plus 2.5 percent of unadjusted basis of qualified property immediately after acquisition, orUBIA.
  - These wage and property limits have no impact on the 20 percent deduction below certain taxable income thresholds (see below), but they phase in over a specified range. (In the case of specified service businesses, the deduction phases out as the limits phase in.)

- Add 20 percent of income from qualified REITs and qualified publicly-traded partnerships.
- But in no event can these combined deduction amounts in the first two bullets exceed 20 percent of taxable income (not including net capital gains).
- Add 20 percent of qualified cooperative dividends.

WHAT IS QUALIFIED BUSINESS INCOME?

- Qualified Business Income is the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer.
  - QBI must be U.S. income included in taxable income for the year.
  - If less than zero, it carries over as a loss from a qualified trade or business in the subsequent year.
  - "Trade or business" is not defined in Section 199A, but the recently proposed regulations (Aug. 18) provide some guidance.
- QBI does not include short-term or long-term capital gains or losses, dividends, certain interests, other statutory exceptions.
- QBI does not include REIT, publicly traded partnership or cooperative income or dividends.
- QBI does not include "reasonable compensation paid to the taxpayer," guaranteed payments to a partner, or Section 707(a) payments to a partner.

WHAT IS A QUALIFIED TRADE OR BUSINESS? (HINT: IT'S NOT A SPECIFIED SERVICES TRADE OR BUSINESS)

A qualified trade or business is defined in the negative. It is any trade or business other than the business of being an employee or a specified services trade or business.

A "specified service trade or business," or SSTB, is any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, or which involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities. (See the related posting **"Are You in the Consulting or the Sales Business?"** for more on SSTBs.)

Owners of SSTB's do not qualify for the 20 percent business income deduction when their taxable income exceeds certain threshold amounts. Below those thresholds, the deduction is available, with a range above the threshold over which the deduction phases out.

MORE GROUND RULES FOR THE CALCULATION

- The threshold amounts are $157,500 ($315,000 for joint returns) and the W-2 and property limitations phase in between $157,500 and $207,500 ($315,000 and $415,000 for joint returns). These thresholds are based on the business owner's taxable income.These amounts will be indexed for inflation.
- QBI is determined separately for each qualified trade or business and then combined with REIT dividends and publicly-traded partnership income. The proposed regulations provide rules for when separate trades or businesses can be aggregated for purposes of calculating the deduction.
- QBI, W-2 wages and UBIA of the separate trades and businesses are allocated among the partner or S corporation shareholder based on the shareholder or partner's allocable share of income or loss of the entity.
- The UBIA of all qualified property is the basis of the 2.5 percent property limitation.
- The statute and proposed regulations provide detail on calculating UBIA. A special 10 year "depreciable period" rule applies.
- The business income deduction is only allowed for income taxes.

In August 2018, the Internal Revenue Service and the Department of the Treasury issued proposed regulations providing detailed guidance on many aspects of the calculation, including the calculation of the applicable QBI, W-2 wage limitation, the UBIA limitation, the definition of specific service trade or business, and special rules regarding taxpayers who own multiple trades or businesses and seek to combine those trades or business for purposes of the business income tax deduction, and taxpayers who seek to divide existing trades or businesses to maximize availability of the deduction.

EXAMPLES

Here are a few straight-forward examples to illustrate aspects of the calculation. In reality, of course, nothing is this straight-forward.

Example 1: Deduction Allowed for Service Business Income Based on Taxable Income

A, a partner in a dermatology practice, has a $300,000 share of partnership income. A and A's spouse, who file a joint return, have no other income or deductions.

Although the practice of dermatology is a specified service trade or business, it is treated like a qualified trade or business because A files a joint return and their income is below the $315,000 threshold. A is allowed the full deduction of 20 percent of A's $300,000 QBI, which is $60,000. The top effective tax rate on A's QBI is 19.2 percent (i.e., the 24 percent top marginal rate otherwise applicable to A's 2018 income, reduced by 20 percent).

Example 2: Deduction Limited Based on W-2 Wages

B, a shareholder in an S corporation engineering firm, has a $500,000 share of S corporation income. B's share of the firm's W-2 wages is $80,000. B and B's spouse, who file a joint return, have $120,000 of salary income and no other income or deductions.

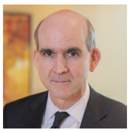
The starting point for calculating B's deduction is 20 percent of B's $500,000 QBI, which is $100,000. As an engineering firm, this is not a specified services trade or business, so the deduction is available even above the threshold phase-in range, subject to the W-2 and UBIA limitations. B's QBI deduction is limited to $40,000, 50 percent of B's $80,000 share of W-2 wages. B's deduction therefore is equal to 8 percent of B's QBI ($40,000 ÷ $500,000 = 8%). The top effective tax rate on B's QBI is 32.2 percent (i.e., the 35 percent top marginal rate otherwise applicable to B's income, reduced by 8 percent).

Example 3: Deduction Limited Based on W-2 Wages and Qualified Property

C, a member in a real estate development LLC, has a $900,000 share of LLC income. C's share of the LLC's W-2 wages is $100,000, and C's share of the LLC's unadjusted basis in qualified property immediately after acquisition (UBIA) is $5 million. C and C's spouse, who file a joint return, have no other income or deductions.

The starting point for calculating C's deduction is 20 percent of C's $900,000 QBI, or $180,000. However, C's QBI deduction is limited to $150,000, the greater of (1) $50,000, which is 50 percent of C's $100,000 share of W-2 wages, or (2) $150,000, which is the sum of $25,000, which is 25 percent of C's $100,000 share of W-2 wages, plus $125,000, 2.5 percent of C's $5 million share of UBIA of qualified property. C's QBI deduction therefore is equal to approximately 16.7 percent of C's QBI ($150,000 ÷ $900,000 ≈ 16.7%). The top effective tax rate on C's QBI is approximately 30.8 percent (i.e., the 37 percent top marginal rate otherwise applicable to C's income, reduced by approximately 16.7 percent).

Thanks for reading this. Please be aware it does not describe all the rules that may apply to your situation. The circumstances of your particular business need to be separately analyzed to determine, in light of all the available guidance, whether and to what extent you may be able to deduct a portion of your business income or make adjustments to increase the amount of your deduction. Consult with a tax professional. In many cases, the savings will be well worth the effort.



Michael G. Riley

Team member bio