November 2018 Client Bulletin

The New Deduction for Qualified Business Income

The Tax Cuts and Jobs Act of 2017 was signed into law on December 22, 2017. The tax act is considered one of the most sweeping pieces of legislation since The Tax Reform Act of 1986. This bulletin focuses on a new deduction for qualified business income. In general, a taxpayer, who is self-employed or a member of a pass-through entity, may claim a deduction for 20% of the qualified business income generated by a qualified trade or business. Some commentators have suggested the deduction has the effect of reducing the tax rate on qualified business income from the top tax rate of 37% for individuals to 29.6%. The purpose of this deduction is to achieve parity among business entities by providing a business deduction to non-corporate tax returns to counter the change to the new corporate tax system. While lawmakers' intent constructing this deduction are worthy, the deduction is filled with cumbersome calculations and unique distinctions.

There are several disparities with respect to this deduction. The first disparity is no employee can take advantage of the deduction; however, independent contractors are eligible. As discussed later, some service qualified trades or businesses are eligible for the full 20% deduction while other owners of service qualified trades or businesses may find their deduction reduced or eliminated. And finally, individuals in low income levels will find it easy to qualify for the full 20%, while high-income taxpayers, even in favored qualified trades or businesses, will find it much more difficult.

There are some unique aspects to this deduction. Business owners, whose business has no employees and no capital assets, with higher taxable income are limited in their ability to use the deduction. Another aspect is the deduction will not be used to compute adjusted gross income. Finally, the deduction is not part of itemized deductions. In essence, taxpayer's taxable income equals adjusted gross income less the sum of itemized deductions and this new business deduction.

The construction of the law provides several new acronyms and calculations in order to calculate the exact deduction. The exact deduction is equal to the lesser of the combined business income amount of the taxpayer or 20% of the taxpayer's taxable income after subtracting net capital gain. In a February 2018 article, Jane Livingstone proposed a four-step process. This four-step process should assist the taxpayer in determining the information required to calculate the deduction. These steps also illustrate the disparities and aspects mentioned above. The steps are as follows:

Step 1 – qualified trade or business (QTB)
Step 2 – qualified business income (QBI)
Step 3 – determination of deductible amount for each trade or business
Step 4 – combined qualified business income amount (CQBIA) and allowed deduction

These steps are also the building blocks to calculate the CQBIA.

The first step is determining if the business is a qualified trade or business. Essentially, everything is a qualified trade or business unless the trade or business is performing services as an employee or the trade or business is characterized as a specified service trade or business. The Regulations recently promulgated by the Treasury Department define a specified service trade or business. The Regulations list thirteen service businesses, which include: health, law, accounting, actuarial science, performing arts, consulting, athletes, financial services, brokerage services, investing and investment management, trading, dealing in securities, and a 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. The last trade or business has three specific industries. The three are 1) a trade or business in which a person receives fees, compensation, or other income for endorsing products or services, 2) a trade or business in which a person licenses or receives fees, compensation or other income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity and 3) a trade or business in which a person receives fees, compensation, or other income for appearing at an event or on radio, television, or another media format. The two typical service industries that are not mentioned in the targeted industries are architecture and engineering.

A trade or business characterized as a specified service trade or business may not benefit from the deduction if the individual owning the trade or business has taxable income exceeding the phase in amounts. For these affected taxpayers, whose adjusted gross income (AGI) exceeds $207,500 for single filers and $415,000 for married filing joint filers, no deduction is available. For taxpayer's whose AGI is less than $157,500 single and $315,000 married filing jointly (MFJ), the deduction is the general calculation outlined in the introduction, or 20% of qualified business income.

The second step is to determine qualified business income. Qualified business generally includes items of income, gain, deduction and loss from a qualified trade or business. There are several exceptions. The exceptions are income from qualified REIT dividends, qualified cooperative dividends, qualified publicly traded partnerships, and income earned outside the United States. Qualified business income does not include reasonable compensation paid to an S Corporation shareholder or any guaranteed payments paid to a partner. Section 1231 business gains and losses and Section 179 expense are items which flow through to a partner or S Corporation shareholder. These two items are typically items of income, gain, deduction and loss attributable to a qualified trade or business. The Regulations were silent on this point, but the likelihood is these items will be included in determining qualified trade or business income.

The third step to determine the deductible amount relies on various inputs due to congressional intent to determine the taxpayers who will benefit. The deductible amount is computed for each trade or business. There are two main calculations for this purpose. The basic calculation is called the 2A calculation. This calculation is the basic 20% of qualified business income from the qualified trade or business. The second calculation is called the 2B calculation. This calculation is the greater of the following:

1) 50% of W-2 wages, or
2) 25% of W-2 wages plus 2.5% of the unadjusted basis of all qualified property.

These calculations are best used to determine the deductible amount with respect to the phase in amounts. These phase in amounts have been discussed previously with a specified service trade or business. For taxpayers whose AGI is under the threshold limits, $157,500 single or $315,000 MFJ, the deduction is equal to the 2A calculation. For taxpayers whose AGI is equal to or over the threshold, $207,500 single or $415,000 MFJ, the allowed deduction is the lesser of 2A or 2B. It bears repeating that a taxpayer in a specified service trade or business does not receive a deduction for AGI limits over the threshold.

For taxpayers whose AGI is in between the two thresholds, there are two possible outcomes:

1) When the 2A calculation is less than 2B, the deduction equals the 2A calculation.
2) When the 2A calculation is greater than 2B, the deduction is 2A reduced by a percentage of the difference between 2A and 2B

The second outcome in effect forces the deduction amount to be equal to the deduction for high income taxpayers.

For taxpayers with one qualified trade or business, the final step is to compare 20% of the taxpayer's taxable income after subtracting net capital gain to the calculation computed from the third step. The lesser of these two amounts is the final deduction. This final comparison is quite simplistic. Once the third step amount is computed for all qualified trades or businesses, this amount is further increased as follows:

1) 20% of qualified REIT dividends
2) 20% of qualified publicly traded partnership income

While this bulletin addresses the new deduction for qualified business income, it does not detail all the ramifications of the new deduction. Low income taxpayers will have no problem qualifying for the deduction. High income taxpayers not in specified service trade or business will be encouraged to maximize their deduction based around potential year-end bonuses. High income taxpayers in a specified service trade or business will be planning to defer income to 2019 or accelerate deductions into 2018 to lower their income below the phased-out levels. If you have any questions concerning the new deduction, please consult with your tax advisor.

Should you have any questions regarding this bulletin, please contact us.

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