The Qualified Business Income Deduction Under the *Tax Cuts and Jobs Act*

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The *Tax Cuts and Jobs Act* (TCJA) made significant changes to corporate and individual taxation, including reducing the top corporate tax rate from 35 percent to a flat 21 percent and the top marginal individual rate from 39.6 percent to 37 percent. With the significant effort to remain competitive in attracting foreign investment, the disparity between corporate tax rates and the individual rates applicable to pass-through business income became apparent during the legislative process. While several factors affect this analysis (including the effect of corporate double taxation), to address this potential disparity, the TCJA created a new deduction under Internal Revenue Code (IRC) Section 199A.

An Overview

The new deduction, which is effective for taxable years beginning after December 31, 2017, and before January 1, 2026, represents 20 percent of a noncorporate business owner's qualified business income (QBI), plus 20 percent of both qualified real estate investment trust (REIT) dividends and publicly traded partnership (PTP) income, and is subject to various thresholds and limitations based on the business's activity type, W-2 wages and qualified property.

QBI is defined under the statute as income effectively connected to a qualified trade or business within the U.S. or Puerto Rico. In addition, the definition of QBI specifically excludes:

- Capital gains and losses
- Dividends
- Interest
- Reasonable compensation
- Guaranteed payments
- Qualified REIT dividends
- Qualified PTP income

The definition of a qualified trade or business excludes trades or businesses involving performing services as an employee and specified service trades or businesses (SSTB), which are those that include the performance of services in any of the following fields:

- Health
- Accounting
- Performance arts
- Brokerage services
- Athletics
- Law
- Consulting
- Actuarial science
- Financial services
- Investing and investment management, trading or dealing in securities, partnership interests or commodities

See this summary for a closer look at each of these SSTB categories.

The qualified trade or business definition also includes a catch-all to exclude any business where the principal asset is the reputation or skill of one or more of its employees. Engineering and architecture firms are specifically excluded from the definition of an SSTB. SSTBs are still eligible for the deduction if certain conditions are met, as discussed below.

The deduction is applied at the owner level for partnerships and S corporations according to the owner's allocable share of qualified income, deductions, gains and losses.

The Limitations

While the deduction is generally determined as 20 percent of QBI, the amount is limited to the greater of:

1) 50 percent of the taxpayer's allocable share of the total **W-2 wages** paid from the qualified trade or business, or
2) 25 percent of the taxpayer's allocable share of the total **W-2 wages** paid from the qualified trade or business plus 2.5 percent of the taxpayer's share of the total unadjusted basis immediately after acquisition of the business's **qualified property**.

W-2 wages include wages subject to withholding, elective deferrals and deferred compensation.

Qualified property includes depreciable tangible property that's held at the end of the year, used in producing QBI and for which the **depreciable period** hasn't ended before the close of the taxable year.

A property's **depreciable period** is the later of:

(1) 10 years following the date the property was placed in service, or
(2) The last day of the last **full** year in the applicable recovery period that would apply to the property, without regard to the alternative depreciation system.

Partnership and S corp owners will take into account their allocable share of the entity's W-2 wages and qualified property.

Limitation Phase-In

To the extent taxable income exceeds $315,000 for married taxpayers filing jointly (MFJ), or $157,500 for other taxpayers, the limitations based on W-2 wages and qualified property will phase in across a range of $100,000 and $50,000, respectively.

For activities that aren't SSTBs, the phase-in only partially applies the W-2 wage and qualified property limitation, until taxable income reaches the full phase-out amounts ($415,000 MFJ). This complicated calculation requires the determination of a phase-in ratio based on the applicable threshold ($315,000 MFJ) versus the full phase-out amount ($415,000 MFJ). The limitation becomes even more complicated for SSTBs. Rather than simply phasing in the W-2 and qualified property limitations, a reduction of actual QBI is phased in as well. When taxable income reaches the full phaseout of $415,000 (MFJ), the entire deduction is eliminated.

Example 1: A and B are equal partners in AB Partnership, which manufactures widgets in Indiana. During the 2018 tax year, the partnership acquires a new building for its operations at a cost of $800,000, with $200,000 allocated to land and $600,000 allocated to the building and a depreciable life of 39 years for tax purposes. It also acquires a widget-making machine at a cost of $100,000. AB Partnership employs individuals with W-2 wages totaling $150,000, and A and B each have guaranteed payments of $75,000 from AB Partnership. The taxable income of the partnership is $700,000, all of which qualifies as QBI. Assuming there's no other income for either A or B at the individual level, each partner has taxable income of $425,000. Assuming A and B are single filers, they both exceed the $207,500 taxable income limitation; therefore, the wage and capital limitations fully apply. However, since the activity isn't an SSTB, A and B are still eligible for the (limited) deduction. The limitation is computed as shown in Figure 1, and each partner would be able to claim a deduction of $37,500 on his respective individual income tax return.

Figure 1: QBI Deduction with W-2 Wage & Capital Limitation

	QBI	W-2 Wages	Qualified Property
Partnership Amounts	$ 700,000	$ 150,000	$ 700,000
Partner Allocable Share (50%)	$ 350,000	$ 75,000	$ 350,000
Wage Limitation (50%)		$ 37,500	
Wage (25%) & Property (2.5%) Limitation		$ 18,750	$ 8,750

Tentative QBI Deduction per Partner (20%) = $70,000

(1) Tentative W-2 Limitation (50%) = $37,500
(2) Tentative W-2 and Property Limitation = $27,500

QBI Limitation [Greater of (1) and (2)] = $37,500

QBI Deduction (lesser of tentative QBI deduction and QBI limitation) = $37,500

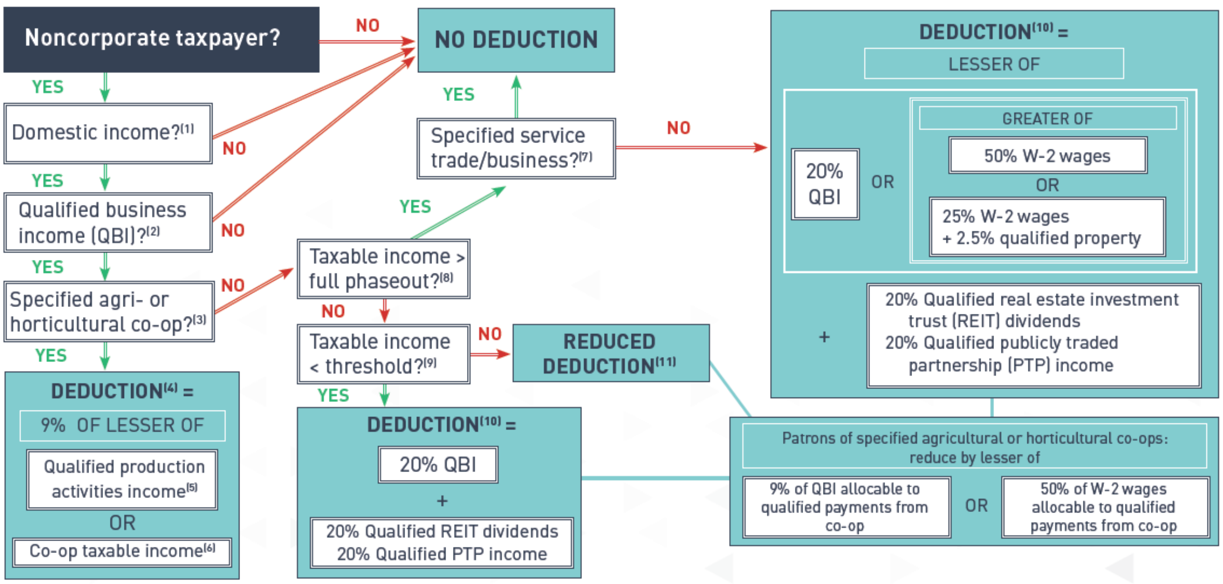
Determining the Final Deduction

A taxpayer's final deduction is ultimately determined according to its **combined QBI**, not to exceed 20 percent of taxable income (determined without regard to capital gains or losses).

Combined QBI includes:

- The QBI deduction, after any applicable limitations, for each of the taxpayer's qualified trades or businesses
- 20 percent of qualified REIT dividends
- 20 percent of qualified PTP income, including any ordinary gain recognized on the disposition of a PTP interest

See below for a flowchart that summarizes the calculation and its various elements.



(1) Domestic: Effectively connected with conduct of trade/business within U.S. & Puerto Rico

(2) QBI: Net amount of items of income, gain, deduction & loss with respect to any qualified trade or business, except
- Reasonable compensation
- Guaranteed payments
- Short-term & long-term capital gain/loss
- Dividend income
- Interest income
- Qualified REIT dividends
- Qualified PTP income

Note: Overall loss treated as loss for purposes of calculation in subsequent year

(3) Specified agricultural or horticultural cooperative: An entity organized & operated on a cooperative basis that is significantly engaged in the marketing, manufacturing, production, growth or extraction of any agricultural or horticultural product, including fertilizer, diesel fuel & other supplies

(4) Deduction limited to 50 percent of W-2 wages allocable to domestic production gross receipts

(5) Qualified production activities income: Domestic production gross receipts less the cost of goods sold, losses & other expenses properly allocable to those receipts

(6) Taxable income determined before any deduction for patronage dividends, per-unit retain allocations & nonpatronage dividends

(7) Specified service trade or business: Any trade or business involving performance of services in fields of
- Health
- Law
- Accounting
- Actuarial science
- Performance arts
- Investing & investment management, trading or dealing in securities, partnership interests or commodities
- Consulting
- Athletics
- Financial services
- Brokerage services
- Principal asset is reputation or skill of one or more of its employees or owners

(8) Full phaseout = $207,500 (single) | $415,000 (married filing jointly (MFJ)), indexed

(9) Threshold = $157,500 (single) | $315,000 (MFJ), indexed

(10) Deduction = Limited to 20 percent of excess of taxable income over the sum of any net capital gain

(11) Reduced deduction: Wage limitation phases in & the deduction for specified service businesses phases out on a pro-rata basis between the threshold & full phase-out amounts

Conclusion

It's important to note the deduction is available to taxpayers claiming the standard deduction as well as those who opt to itemize instead. In addition, the deduction is determined without regard to alternative minimum tax preference items related to the trade or business. Finally, where overall QBI is negative, the amount is carried forward and treated as a loss from a qualified business in the following year.

There are multiple strategies available to help taxpayers increase their benefit from this new deduction. This may be an opportunity to consider your choice of entity structure in light of tax reform. For a closer look at several entity choice considerations beyond the new QBI deduction, see this related one-page summary.

On August 8, 2018, the IRS and U.S. Department of the Treasury released proposed regulations under IRC §199A. See this **BKD Thoughtware®** alert for a summary of the guidance and clarification provided in those regulations. Be sure to visit BKD's Tax Reform Resource Center for more information. Contact your trusted BKD advisor to discuss how this new deduction, and possible planning strategies, may affect your specific tax situation.