

The Tax Cuts and Jobs Act: Qualified Business Income Deduction

By Susan Queary and Kelly Nelson

The Tax Cuts and Jobs Act created a new qualified business income deduction (or Section 199A deduction) for the owners of sole proprietorships and pass-through entities such as partnerships, LLCs and S corporations.

These owners are not limited to individual taxpayers. They can include estates and trusts, but specifically *exclude* C corporations.

Background

Income from pass-through entities and sole proprietorships was (and is) taxed on the owners' tax returns at the owners' tax rates. The tax act reduced the maximum federal tax rate for these owners to a maximum rate of 37 percent, correspondingly reducing the tax due on their business income.

The tax rate for C corporations was reduced much more dramatically under the tax act, to a flat rate of 21 percent. As this rate is much lower than the applicable rate for other business entities, the difference provides a rationale for creating the new deduction.

Introducing the Qualified Business Income Deduction

Under the tax act, the non-corporate owner of a qualified U.S. trade or business became eligible for a qualified business income deduction of up to 20 percent of qualified business income — subject to several exceptions, limitations, phase-ins and phase-outs.

The deduction is effective beginning in 2018 and extends through 2025.

Exclusion for Specified Service Businesses

The deduction is not available to *specified services businesses*, including most professional services — lawyers, accountants, actuaries, health professionals, brokers, investment managers, financial planners, athletes and performing artists, to name a few. An exception was made for engineers and architects.

The tax act distinguishes a specified service business as 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.

The tax act also makes an exception for specified service businesses based on adjusted gross income. Owners with incomes below a specified threshold amount are eligible for the deduction, although it phases out for those with higher incomes.

Determining Qualified Business Income

Typically, qualified business income is the *net income* a trust, estate or individual receives as the owner of an active U.S. trade or business. It therefore includes gains and losses and deductions.

It does not include reasonable compensation to an owner, investment income not allocable to the trade or business, or certain guaranteed payments.

Calculating the Deduction

The deduction requires a highly complex calculation that varies depending on certain factors, including the type of business and the owner's income. Elements of the calculation require guidance from rules that are yet to be developed by the U.S. Treasury.

The amount of the deduction is equal to 20 percent of qualified business income from the trade or business (subject to wage and other limitations), plus 20 percent of REIT dividends and qualified publicly traded partnership income.

The wage limitations are generally 50 percent of W-2 wages for the year, or 25 percent of W-2 wages plus 2.5 percent of the unadjusted basis of tangible depreciable property. The latter is particularly valuable for real estate businesses.

Additionally, the amount of the deduction cannot exceed 20 percent of the owner's net taxable income reduced by net capital gains.

Rules pending from the U.S. Treasury will include guidance on allocating the deduction between fiduciaries and beneficiaries of estates and trusts.

Impact of Taxable Income Thresholds on the Calculation

The calculation and applicable limits and phase-ins depend on three *taxable income* thresholds. For estates and trusts, the threshold amounts are pending.

Taxable Income	Specified Service Businesses	All Other Businesses
≤ \$157,500 (Single) or ≤ \$315,000 (Married)	Eligible for 199A No W-2 wage limit	Eligible for 199A No W-2 wage limit
\$157,501 - \$207,499 (Single) or \$315,001 - 414,999 (Married)	Eligible for 199A Phases out based on income W-2 wage limit phases in	Eligible for 199A W-2 wage limit phases in
≥ \$207,500 (Single) or ≥ \$415,000 (Married)	Not eligible	Eligible for 199A Subject to W-2 wage limit

The qualified business income deduction is an evolving and complex area of the federal tax code. Consult with a tax advisor before making any business or financial decisions based on this deduction, including any change in business entity.

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