

## The New Tax Law: 20% Deduction for Qualifying Business Income

On December 22, 2017 President Trump signed H.R. 1, known as the Tax Cuts and Jobs Act, into law making widespread changes to the Internal Revenue Code. These changes went into effect January 1, 2018, and it is no overstatement to say that this mammoth tax bill will have a significant impact on virtually every business and individual.

Among those changes, Congress reduced the top tax rate for “C” corporations from 35% to a flat tax rate of 21%, so it felt certain types of business income from pass-through entities (e.g., S Corporations, Partnerships, Sole Proprietors, Trusts, and Estates), and the income of certain Cooperatives, should also get some form of tax rate reduction. However, instead of providing a lower tax rate for this type of business income, effective for tax years beginning after 2017, the *New Law* creates a new 20% deduction that is generally provided to noncorporate taxpayers receiving qualifying income. The provision was added under §199A of the Internal Revenue Code as revised.



NOTE: While most new tax provisions primarily impacting businesses under the *New Law* do not have an expiration date, this 20% deduction does expire after 2025!

### Income Qualifying for the 20% Deduction

The following types of income generated by partnerships, S corporations, sole proprietorships, trusts, and estates may qualify for the 20% deduction: “Qualified Business Income,” “Qualified Cooperative Dividends,” “Qualified REIT Dividends,” and “Qualified Publicly-Traded Partnership Income.” Please note that, of these four types of qualifying income, the most common will, in all likelihood, be “Qualified Business Income” (QBI). Consequently, the remainder of this discussion focuses only on QBI.

#### “Qualified Business Income.”

“Qualified Business Income” (QBI) is generally defined as the net amount of qualified items of income, gain, deduction, and loss with respect to “any” trade or business other than:

1. Certain personal service businesses known as “Specified Service Trade Or Businesses” (described in more detail below), and
2. The trade or business of performing services “as an employee.”

QBI does not include:

1. Dividends, investment interest income, short term capital gains, long term capital gains, income from annuities, commodities gains, foreign currency gains, etc.,
2. Reasonable compensation paid by a Qualified Trade of Business for services rendered to the taxpayer claiming the 20% deduction,
3. Any “guaranteed payment” paid to a partner for services actually rendered to or on behalf of the partnership, or
4. To the extent provided in regulations, any amount allocated or distributed by a partnership to a partner who is acting other than in his or her capacity as a partner for services rendered to a partnership.

### Determining The Amount Of A Taxpayer’s 20% Deduction for a “Qualified Trade or Business Income”

Step 1 – Calculate the initial deduction amount with respect to the taxpayer’s share of each “Qualified Trade or Business.” The initial deduction amount for each “Qualified Trade of Business interest” is the lesser of:

33 Blair Park Rd.  
Williston, VT 05495

49 North Main St.  
Rutland, VT 05702

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1. 20% of the owner's share of "Qualified Business Income" (QBI) from the owner's interest in each "Qualified Trade or Business," or
2. The owner's share of the W-2 Wage and Capital Limitation (if applicable) for each such trade or business interest.

Step 2 – Total the initial deduction amounts from each "Qualified Trade or Business" interest. Add the initial deduction amounts in Step 1 for each "Qualified Trade or Business" interest. This is the taxpayers' tentative deduction.

Step 3 – Apply overall limitation. The aggregate deductions computed in Step 2 cannot exceed 20% of the excess of the taxpayer's "taxable income" over the taxpayer's "net capital gains."

## W-2 Wage And Capital Limitation.

The "W-2 Wage and Capital Limitation" is the greater of:

1. 50% of the taxpayer's allocable share of the business's W-2 wages paid with respect to each "Qualified Trade or Business" properly allocable to "Qualified Business Income," or
2. The sum of 25% of the taxpayer's allocable share of W-2 wages with respect to each "Qualified Trade or Business" plus 2.5% of the taxpayer's allocable share of unadjusted basis of tangible depreciable property held by the business at the close of the taxable year and which is used for the production of "Qualified Business Income."

This limitation is generally designed to ensure that the maximum 20% deduction is available only to qualified businesses that have sufficient W-2 wages, sufficient tangible depreciable business property, or both.

## W-2 Wages Explained:

- W-2 amounts include actual wages paid by employer reported to SSA
- Allocable W-2 wages for a shareholder are, like all other items of an S corporation, allocated pro-rata, on a per-share/per-day basis
- Wages paid to an employee include any elective deferrals into a §401(k)-type vehicle or other deferred compensation
- W-2 wages do NOT INCLUDE payments to an independent contractor or management fees

## Unadjusted Basis Explained:

- Depreciation deductions relative to the property are not taken into account.
- Basis is the historical cost of the property "immediately after acquisition".
- Any asset that was fully depreciated prior to 2018, unless it was placed in service after 2008, will not count towards basis.
- Assets included are based on the date the property is placed in service and ends on the LATER OF:
  - 10 years, or
  - The last day of the last full year in the asset's "regular" depreciation period.

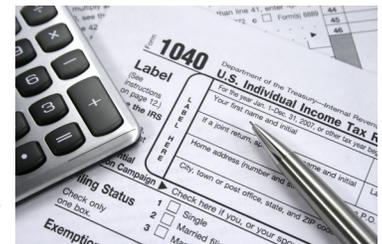
## Owners Exempt From The W-2 Wage And Capital Limitation.

Otherwise qualifying owners of pass-through entities are entirely exempt from the W-2 Wage And Capital Limitation if the owner's "taxable income" (computed without regard to the 20% deduction) does not exceed \$157,500 or \$315,000 (if filing jointly). *Caution!* The Wage and Capital Limitation phases in as an owner's taxable income goes from more than \$157,500 to \$207,500 or from more than \$315,000 to \$415,000 (if filing jointly).

For instance, assume Owner A and Owner B each own 50% of an S corporation and each files a joint return. If Owner A had "taxable income" below \$315,000, she would be fully exempt from the W-2 Wage Capital Limitation. However, if Owner B's "taxable income" equaled or exceeded \$415,000, he would be fully subject to this limitation.

**Example.** Assume that taxpayer owns 50% of an S corporation (that operates a retail store). The S corporation has \$700,000 of QBI. The taxpayer has \$315,000 of "taxable income," has \$15,000 of "net capital gain," and files a joint return. Since the taxpayer's "taxable income" is not over \$315,000, he is not subject to the W-2 Wage and Capital Limitation. Therefore, his 20% deduction amount is computed as follows: The lesser of:

1. \$70,000 (20% of \$350,000 - the owner's share of



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the S corporation's QBI of \$700,000), or

2. 20% of the owner's "taxable income" (\$315,000) less his "net capital gains" (\$15,000) or \$300,000. Therefore the amount of the owner's 20% deduction is limited to \$60,000 ( $\$300,000 \times 20\%$ ).

### **"Specified Service Trade Or Businesses" Do Not Qualify For The 20% Deduction Unless Owner's Taxable Income Less Than \$415,000/\$207,500.**

A "Specified Service Trade or Business" (SSTB) generally does not qualify for the 20% deduction. An SSTB is any trade or business activity involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, 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 any trade or business involving the services of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.

**Certain Owners Of An SSTB May Qualify.** The 20% deduction is allowed for an owner of an SSTB if the owner's "taxable income" (computed without regard to the 20% deduction) does not exceed \$157,500 or \$315,000 (if filing jointly). The deduction is phased-out as an owner's taxable income goes from more than \$157,500 to \$207,500 or from more than \$315,000 to \$415,000 (if filing jointly).

**Example.** Assume the taxpayer is a physician who owns 50% of an S corporation (that operates the physician's medical practice) and the S corporation has \$700,000 of QBI. The taxpayer has \$315,000 of "taxable income," \$15,000 of "net capital gain," and files a joint return. Since the taxpayer's "taxable income" is not over \$315,000:

1. She may qualify for the 20% deduction even though she is the owner of an SSTB, and
2. She is not subject to the W-2 Wage and Capital Limitation (i.e., her taxable income on her joint return does not exceed \$315,000).

Therefore, her 20% deduction amount is computed as follows: The lesser of:

1. \$70,000 (20% of \$350,000 - the owner's 50% share of the S corporation's QBI of \$700,000), or

2. The owner's share of the W-2 Wage and Capital Limitation for the trade or business (which does not apply because owner's taxable income does not exceed \$315,000).

However, the deduction may not exceed 20% of the owner's "taxable income" (\$315,000) less her "net capital gains" (\$15,000) which equals \$300,000. Therefore the amount of the owner's 20% deduction is \$60,000 ( $\$300,000 \times 20\%$ ).

### **Rental Property**

Owners of rental property are entitled to take the §199A deduction. If the taxpayer's taxable income is at or below the \$157,500/\$315,000 threshold amounts, they are eligible for the lesser of 20% of QBI or 20% of "taxable income".

For example, if Eric owns three rental properties which generate \$20,000, \$40,000 and (\$10,000) of rental income/loss respectively, then the normal taxable income and wage investment phase/in rules will apply:

- Eric's QBI equals \$50,000
- Eric's §199A deduction equals \$10,000 assuming his taxable income exceeds \$50,000 and is less than \$157,500 (single) or \$315,000 (joint).

If the taxpayers income is at or above the \$157,500/\$315,000 thresholds then the wage and capital limitation will apply.

### **QBI from Sale of Rental Property.**

- Gain from sale of real estate investment is QBI to the extent it represents past depreciation.
- Gain from the sale of a real estate investment which represents appreciation in the value of the property does not constitute QBI and would reduce taxable income.

### **Other Rules.**

The 20% deduction:

1. Does not reduce the owner's "self-employment" income for purposes of determining S/E Tax,
2. Does not reduce the owner's "adjusted gross income" (AGI), although it does reduce the owner's "taxable income," and
3. Is available to taxpayers using the standard deduction.

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4. Deduction cannot exceed 20% of the excess of taxable income over net capital gain
5. If QBI is less than zero it is carried forward and treated as a loss from a qualified business in the following year

### General Planning Observations Regarding The 20% Deduction.

In light of these rules, owners of pass-through entities should consider the following:

- **W-2 Employee vs. Owner.** An “employee” of a business that generates QBI would not qualify for the 20% deduction for his or her W-2 wages, but the owner of the same pass-through business would qualify with respect to the owner’s share of the business’s pass-through QBI. Consequently, employees (particularly higher-paid employees) will have a tax incentive to become “owners” of their pass-through employers, rather than merely W-2 employees.
- **W-2 Compensation Paid To S Corp Owner/ Employee.** Currently, S corporation shareholder/ employees have an incentive to pay themselves W-2 wages as low as possible because only the shareholder’s W-2 income from the S corporation is subject to FICA taxes. Other income of the shareholder from the S corporation is generally not subject to FICA or Self-Employment (S/E) taxes. However, if the IRS determines that an S corporation shareholder/employee has taken unreasonably “low” compensation from the S corporation, the IRS generally argues that other amounts the shareholder has received from the S corporation (e.g., distributions) are disguised “compensation” and should be subject to FICA taxes.
- In light of the new 20% deduction, S corporation shareholder/employees have an additional tax incentive to keep their W-2 wages as low as possible. This is because their W-2 wages do not qualify for the new 20% deduction, while their pass-through Qualified Business Income will qualify.

*Planning Alert!* With this new 20% deduction, the Service will have an additional reason to closely scrutinize whether the W-2 wages paid to an S corporation’s shareholder/employee is unreasonably low.

- **Payments By A Partnership To A Partner For Services.** As noted above, a partner’s pass-

through share of Qualified Business Income does qualify for the 20% deduction, while the 20% deduction does not apply to:

1. Any amount that is a “guaranteed payment” for services actually rendered to or on behalf of a partnership, or
2. As provided in regulations to be issued by the IRS, any amount allocated or distributed by a partnership to a partner who is acting other than in his or her capacity as a partner for services. Presumably, going forward it appears likely the IRS will more closely scrutinize whether a partner who is providing services to the partnership in a capacity other than a partner is being paid adequate compensation-type payments by the partnership.

- **Owners Of A “Specified Service Trade Or Businesses” (SSTB).**

As discussed above, even though owners of an SSTB generally do not qualify for the 20% deduction, they do qualify fully if their taxable income does not exceed \$157,500 or \$315,000 (if filing a joint return). Consequently, starting in 2018, owners of SSTBs will place a premium on potential deductions that could cause their taxable income to drop below the \$315,000 or \$157,500 thresholds.

*Planning Alert!* The New Law has significantly increased the amount that can be immediately deducted under Sections 179 and 168(k) for purchases of qualifying depreciable property. In certain situations, these increased deductions could give owners of an SSTB a significant tax benefit by preserving the 20% deduction for “Qualified Business Income” (e.g., by reducing the owner’s taxable income below the income thresholds that will allow the SSTB owner to take all or a portion of the 20% deduction).

For more information and to schedule a strategy session to reduce your overall tax liability please call our office at 802.878.1963 (Williston) or 802.775.7132 (Rutland).

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