

# Tax Cuts and Jobs Act-New Deduction for Qualified Business Income

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Starting in 2018, the Tax Cuts and Jobs Act (TCJA) may provide a substantial tax benefit to individuals with “qualified business income” (“QBI”) or passthrough income, from various sources including a partnership, S corporation, LLC, sole proprietorship, PTP, cooperative, or a REIT that pays ordinary dividends. However, the complexities surrounding this new deduction can be formidable, most particularly for business owners with interests in passthrough entities, and taxpayers who are involved with multiple trade or business activities. Many relevant details about the calculations are currently unclear, but taxpayers and advisors will need to address these rule changes based on the available information as we start to work through 2018 tax planning.

The deduction can be up to 20% of QBI from a partnership, S corporation, or sole proprietorship, defined as the net amount of items of income, gain, deduction, and loss with respect to the trade or business. The business must be conducted within the U.S. to qualify, and specified investment-related items are not included, e.g., capital gains or losses, dividends, and interest income (unless the interest is properly allocable to the business). The trade or business of being an employee does not qualify. Also, QBI does not include reasonable compensation received from an S corporation, or a guaranteed payment received from a partnership for services provided to a partnership's business, which was intended to prevent taxpayers from converting compensation income into trade or business income that could be eligible for the deduction.

The deduction is limited, and is the lesser of:

20% of the qualified business income from the taxpayer's trade or business, OR the greater of:

- 50% of the total W-2 wages of the business paid to all employees, or
- 25% of the W-2 wages, plus 2.5% of the original acquisition cost of the business' real property.

The 20% deduction is taken "below the line" (i.e., it reduces taxable income but not adjusted gross income), and it is available regardless of whether an individual itemizes deductions or claims the standard deduction. In general, the deduction cannot exceed 20% of the excess of taxable income over net capital gain. If QBI during a year is less than zero, the amount is treated as a loss from a qualified business in the following year, which is one of many new items that taxpayers who stand to benefit from this deduction will need to track. Assuming a high-income taxpayer is eligible to claim the full 20% deduction for a given trade or business, the Federal tax rate applicable to the ordinary income from that business would be reduced from the maximum rate of 37% down to 29.6%.

QBI must be derived from a "qualified trade or business", which leads to the obvious question of what is considered for this purpose to be a qualified trade or business? More importantly, what is **not** considered to be a qualified trade or business? This question is answered clearly in some cases, but we expect that additional guidance will be required.

The QBI rules borrow fairly extensively from existing §1202 provisions defining qualified small businesses. Simply put, a qualified trade or business is any business or trade, **other** than businesses that have been deemed a **specified service business or trade** or an employee performing services as a trade or business. Examples of a specified service business or trade include law firms, accounting and consulting firms, financial services, investing/investment management, commodities/securities/partnership interest dealing or trading, medical practices, athletes, performing arts, brokerage services, and actuarial science. It also includes the murky concept of a business where the principal asset of the business is the reputation or skill of one or more of its employees or owners.

### **Specified Service Business or Trade Considerations**

For taxpayers with taxable income above \$157,500 (\$315,000 for joint filers), an exclusion from QBI of income from specified service businesses or trades is phased in, meaning that these taxpayers may be able to claim the 20% deduction even if their trade or business were on the above list of exclusions. The phase in works as follows:

- If taxable income is at least \$50,000 above the threshold, i.e., \$207,500 (\$157,500 + \$50,000), all of the net income from the specified service trade or business is excluded from QBI.
  - Joint filers would use an amount \$100,000 above the \$315,000 threshold, or, \$415,000.

- If taxable income is between \$157,500 and \$207,500, only that percentage of income derived from a fraction the numerator of which is the excess of taxable income over \$157,500 and the denominator of which is \$50,000 is excluded. So, e.g., if taxable income is \$167,500 (\$10,000 above \$157,500), only 20% of the specified service income would be excluded from QBI ( $\$10,000/\$50,000$ ).
- For joint filers, the same operation would apply using the \$315,000 threshold, and a \$100,000 phase-out range.

Additionally, for taxpayers with taxable income above the threshold amounts, a limitation on the amount of the deduction is phased in based either on wages paid or wages paid plus a capital element (rewarding business owners who hire people and make capital expenditures within the U.S.).

The TCJA's treatment of passthrough entities will be very complicated in many cases, and regulations or other guidance aimed at clarifying many of the details will be needed. Treasury and the IRS will have plenty of issues to address in the QBI area as well as other complex areas impacted by the TCJA, and we hope that guidance will be available soon so that taxpayers can incorporate the new rules correctly into their 2018 tax planning. We will keep you informed as further guidance is provided. In the meantime, if you have any questions about how you can prepare your business for these changes, contact Jason Flashberg, tax partner, at [jason.flashberg@hcv.com](mailto:jason.flashberg@hcv.com), or Sarah Tewner, tax principal, [sarah.tewner@hcv.com](mailto:sarah.tewner@hcv.com).