Views & Visions

A publication of Bowles Rice LLP

Summer 2018

Qualified Business Income: Federal Tax Reform Introduces a Significant New Deduction

David A. DeJarnett
Bowles Rice LLP

David A. DeJarnett is a partner in the Martinsburg, West Virginia office of Bowles Rice. As leader of the firm's Tax Team, he practices in the areas of private client services, with a concentration in estate and trust planning, estate and trust administration, business and tax planning and tax controversies.

Since the passage of 2017's Tax Cuts and Jobs Act, DeJarnett has made numerous presentations on how the new federal tax reforms impact businesses, nonprofits and individuals. He has served as president of the West Virginia Tax Institute and on the faculty of the Institute for International Training, Trade and Development Inc., at Shepherd University in Shepherdstown, West Virginia.

He has been recognized by *The Best Lawyers in America* and West Virginia *Super Lawyers*, and is peer-review rated AV by Martindale-Hubbell.

DeJarnett earned his bachelor's and law degrees from West Virginia University, and an LL.M. (Master of Law) in taxation, with distinction, from Georgetown University.

A significant new tax deduction took effect in January of this year as a result of 2017's Tax Cuts and Jobs Act ("TCJA"). This deduction should provide a substantial tax benefit to individuals with qualified business income ("QBI") from a partnership, S corporation, LLC, or sole proprietorship. This income is sometimes referred to as "pass-through" income.

The deduction is 20 percent of your 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 your 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.

The deduction is taken "below the line," i.e., it reduces your taxable income but not your adjusted gross income. But it is available regardless of whether you itemize deductions or take the standard deduction.

The deduction is taken "below the line," i.e., it reduces your taxable income but not your adjusted gross income. But it is available regardless of whether you itemize deductions or take the standard deduction. In general, the deduction cannot exceed 20 percent of the excess of your taxable income over net capital gain. If QBI is less than zero, it is treated as a loss from a qualified business in the following year.

Rules are in place (discussed below) to deter high-income taxpayers from attempting to convert wages or other compensation for personal services into income eligible for the deduction.

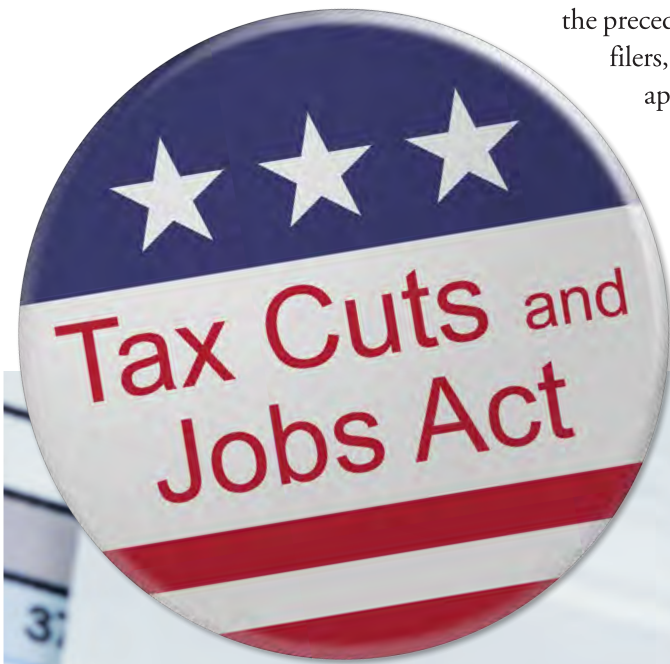
For taxpayers with taxable income above $157,500 ($315,000 for joint filers), an exclusion from QBI of income from "specified service" trades or businesses is phased in. These are trades or businesses involving the performance of services in the fields of health, law, consulting, athletics, financial or brokerage services, or where the principal asset is the reputation or skill of one or more employees or owners.

Here's how the phase-in works: If your 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, viz., $415,000.) If your taxable income is between $157,500 and $207,500, you would exclude 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. So, for example, if taxable income is $167,500 ($10,000 above $157,500), only 20 percent 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 more than the above thresholds, a limitation on the amount of the deduction is phased in, based either on wages paid or wages paid plus a capital element. Here's how it works: If your taxable income is at least $50,000 above the threshold, i.e., $207,500 ($157,500 + $50,000), your deduction for QBI cannot exceed the greater of (1) 50 percent of taxpayer's allocable share of the W-2 wages paid with respect to the qualified trade or business, or (2) the sum of 25 percent of such wages plus 2.5 percent of the unadjusted basis immediately after acquisition of tangible depreciable property used in the business (including real estate).

So, if your QBI is $100,000, leading to a deduction of $20,000 (20 percent of $100,000),but the greater of (1) or (2) above is only $16,000, your deduction would be limited to $16,000, i.e., it would be reduced by $4,000. And if your taxable income is between $157,500 and $207,500, you would only incur a percentage of the $4,000 reduction, with the percentage worked out via the fraction discussed in the preceding paragraph. For joint filers, the same operations would apply using the $315,000 threshold, and a $100,000 phase-out range.



Other limitations may apply in certain circumstances, e.g., for taxpayers with qualified cooperative dividends, qualified real estate investment trust (REIT) dividends, or income from publicly traded partnerships.

Obviously, the complexities surrounding this substantial new deduction can be formidable, especially if your taxable income exceeds the threshold discussed above. If you wish to work through the mechanics of the deduction, with particular attention to the impact it can have on your specific situation, please contact a member of the Bowles Rice Tax Team.

After this edition went to press, new updates and regulations pertaining to the Qualified Business Income deduction were released.

For details, please visit:
www.bowlesrice.com/tcja.html