Understanding the New Qualified Business Income Deduction

07/15/18 | Jeramie J. Fortenberry, JD, LLM

On December 22, 2017, President Donald Trump signed the Tax Cuts and Jobs Act (*Act*) into law. The Act made sweeping changes to tax planning for all taxpayers, including corporations, small businesses, and individuals. The Act is unquestionably the biggest tax reform in over three decades and has consequences for almost all sectors of the American economy.

This article summarizes the significant business tax reforms introduced by the Act—including a new deduction that effectively reduces taxes on owners of pass-through businesses and a reduced corporate income tax rate—and concludes with a discussion of the planning opportunities now available for business owners and their advisors.

Temporary Deduction for Pass-through Businesses

One of the Act's most sweeping changes is the reform of the tax regime that applies to pass-through businesses—sole proprietorships, partnerships, S corporations, and limited liability companies taxed as partnerships or S corporations.

Owners of pass-through businesses currently pay tax at their individual tax rates, which could reach as high as 37 percent under the Act. The owners report income from pass-through businesses on their personal income tax returns, regardless of whether the business distributes the income. As discussed below, the Act reduces the effective rate of income tax on most pass-through businesses by providing owners with a 20 percent deduction.

Deduction for Qualified Business Income

For tax years beginning in 2018 and ending in 2025, the Act creates a new deduction of 20 percent to apply against income of pass-through businesses. The deduction applies at the owner level and also applies to 20 percent of qualified real estate investment trust (REIT) dividends, qualified cooperative dividends, and qualified publicly traded partnership income. The deduction *is* available for trusts and estates that own pass-through businesses.

The deduction applies to qualified business income (QBI), which is defined as the net amount of *qualified items of income, gain, deduction, and loss* with respect to *a qualified trade or business of the taxpayer*. "Qualified items of income, gain, deduction, and loss" includes business income other than investment income. QBI does not include wages, dividends, investment interest income, capital gains (whether short-term or long-term), commodities gains, or foreign currency gains.

"Qualified Trade or Business" Limitation

Only a *qualified trade or business* may qualify for the deduction. While the definition of *qualified trade or business* is broad, it excludes some activities. Notably, it excludes a category of businesses called *specified service businesses*. The definition of *specified service business* includes:

- any trade or business involving the performance of services in the fields of health, law, consulting, athletics, financial services, and 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 owners; and
- any trade or business which involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.

Although the general definition of *specified service business* excludes many small businesses from being *qualified trades or businesses*, the Act provides an important exception: Joint filers with income below $315,000 and other taxpayers with income below $157,500 can claim the deduction fully on income from specified service businesses. This exception is phased out for taxpayers that exceed the threshold. The phaseout occurs over the next $100,000 for joint filers and $50,000 for other taxpayers. No deduction is available to owners of services businesses if their income exceeds $415,000 for joint filers or $207,500 for other taxpayers. For purposes of this threshold, taxable income is determined without regard to the deduction. The threshold is also inflation-adjusted under the Act.

The definition of *qualified trade or business* also excludes the trade or business of performing services as an employee. Amounts paid to an owner-employee—for example, an S corporation shareholder that is also an employee—as reasonable compensation are not included in QBI. Similarly, if a partnership makes a guaranteed payment under Internal Revenue Code (*Code*) § 707(c) or a payment for services under Code § 707(a), those payments are not included in QBI.

Determining the Amount of the Deduction

The deduction applies to the taxpayer's combined QBI amount for the taxable year. This includes the sum of all deductible amounts determined by each qualified trade or business that the taxpayer owns. The combined QBI for the year also includes up to 20 percent of the taxpayer's qualified REIT dividends and qualified publicly traded partnership income. QBI income does not include income that is not effectively connected with the operation of a U.S. trade or business.

The deductibility of the taxpayer's combined QBI is subject to limitations. The deduction for each qualified trade or business is the lesser of:

- twenty percent of the taxpayer's QBI for that trade or business; or

- the greater of (a) 50 percent of the W-2 wages with respect to the trade or business or (b) the sum of 25 percent of the W-2 wages with respect to the trade or business and a capital component consisting of 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property.

The potentially higher limit for businesses with high basis in qualified property benefits capital-intensive businesses—including real estate businesses—with a low payroll but significant capital investments.

For purposes of this limitation, *qualified property* means tangible property of a character subject to depreciation that is held by—and available for use in—the qualified trade or business at the close of the taxable year, and which is used in the production of QBI, and for which the *depreciable period* has not ended before the close of the taxable year. The *depreciable period* with respect to qualified property of a taxpayer begins on the date that the property is placed in service and ends on the later of 10 years or the last day of the applicable recovery period under Code § 168.

The W-2 wage limit has the same threshold that applies to specified service businesses. It does not apply to joint filers with income below $315,000 and other taxpayers with income below $157,500. It is phased in for taxpayers with income over these amounts and applies fully to joint filers with income over $415,000 and other taxpayers with income over $207,500. The income limit is inflation-adjusted, and taxable income is determined without regard to the deduction.

The W-2 wage limit does not apply to income from publicly traded partnerships or income from the disposition of interests in publicly traded partnerships, but the specified service business limit still applies.

The deduction for QBI does not reduce adjusted gross income and is not dependent on whether taxpayers itemize or take the standard deduction. The deduction cannot exceed the taxpayer's taxable income (after reduction for qualified capital gain). It is expected that new worksheets or forms will be promulgated by the IRS to help calculate and report this deduction.

Highest Effective Tax Rate for Pass-through Businesses

The 20 percent deduction for QBI creates an effective top tax rate of 29.6 percent for owners of pass-through businesses. The 29.6 percent rate is calculated based on the top individual income tax rate of 37 percent using the following formula: 37% * (100 percent - 20 percent). This yields a 20 percent rate reduction. Although this rate is less than the reduction in the corporate income tax rate, it exceeds the amount of the reduced rates on individual taxpayers.

Sunset of Deduction for Qualified Business Income

The deduction is effective for tax years beginning after December 31, 2017, and sunsets for tax years beginning after December 31, 2025. This sunset provision was part of political maneuvering to avoid increasing the federal deficit over the long term, but it opens the Act up to criticism. Unlike the reduction to the tax rates that apply to C corporations, discussed below, the preferential tax treatment for pass-through businesses will expire. If allowed to expire on December 31, 2025, the old tax rules for pass-through businesses would return on January 1, 2026 to the rules in effect before the Act's passage (i.e. the rules we had for 2017). Critics argue that the long-term benefit to C corporations, coupled with a short-term benefit to the owners of small businesses, further demonstrates that the Act is aimed more at big business interests than the middle class.

Reduced Corporate Tax Rate and Repeal of Corporate Alternative Minimum Tax

C corporations pay tax on their own income, and their shareholders pay tax again when the income is distributed as dividends. Historically, this double-taxation regime has made C corporations an unattractive option when choosing a form of entity. The Act makes several changes that may make C corporations a more viable alternative for some clients.

Under prior law, taxable income of a C corporation was taxed under a four-step graduated rate structure at rates of 15, 25, 34, and 35 percent. Effective January 1, 2018, the Act eliminates this graduated rate structure, taxes all corporate income at 21 percent. The Act also repeals the corporate alternative minimum tax (AMT). Unlike the deduction for QBI of pass-through businesses, there is no sunset provision for the reduced corporate income tax rate or corporate AMT repeal.

Planning Under the Act

The reduction of the corporate income tax rate from a high of 35 percent to a flat 21 percent and the new 20 percent deduction for QBI of pass-through businesses could affect the decision of what type of business entity is most tax-efficient for the client. This decision involves multiple considerations, including the business's current and expected payroll and equipment purchases, the possibility that the business will be sold, and the effect of state-level income taxes.

Depending on the owner's tax bracket, using a C corporation may result in a lower tax burden on operating income. As long as the owner's effective marginal rate is more than 21 percent, that rate will exceed the amount that the C corporation would pay on current earnings. But this up-front savings comes at a cost: The income of the C corporation will eventually be taxed again when it is distributed to the owner as dividends. When the 21 percent rate paid by the corporation is added to the tax on the dividend to the owner, it is likely that the aggregate tax on the income earned by the C corporation will exceed the maximum 29.6 rate that applies to owners of pass-through businesses. Still, the client's goals must be considered. A client that plans to reinvest all income into the business and offer it in a public offering may be best served by the C corporation structure.

The choice-of-entity decision must also consider the built-in expiration of the 20 percent deduction for QBI of pass-through businesses. Unlike the reduced rate that applies to C corporations, which is permanent, the 20 percent QBI deduction for pass-through businesses expires on December 31, 2025. If, after considering the client's goals, the pass-through entity provides only a slight advantage over a C corporation, the client should be advised that this slight advantage may disappear in 2026. All else being equal, pass-through

businesses will likely remain a better choice. If changes must be made in 2026, it is usually more tax-efficient to convert from a pass-through business to a corporation than to convert from a C corporation to a pass-through business.

Unlike other owners of pass-through businesses, owners of specified service businesses—including businesses that perform services in the fields of health, law, consulting, athletics, financial services, and brokerage services—are subject to income limitations. They do not qualify for the 20 percent QBI deduction if their income exceeds $415,000 for joint filers or $207,500 for other taxpayers. If their income is below $315,000 for joint filers and $157,500 for other taxpayers, the full 20 percent deduction is available. Between these income levels, the deduction phases out. Additional details about the phaseout will likely be promulgated by the IRS as it implements this law.

Full 20% QBI Deduction Available	**Phaseout Applies - Partial QBI Deduction Available**	**No QBI Deduction Available**
Income less than $315,000 for joint filers and $157,500 for other taxpayers	Between $315,001 and $414,999 for joint filers and $157,501 and $207,499 for other taxpayers	Income over $415,000 for joint filers or $207,500 for other taxpayers

These thresholds apply in 2018 and will be adjusted for inflation in subsequent years

These thresholds make it important to determine what income is derived from specified service businesses and what income is derived from other sources. Business owners that receive income from multiple sources should consider forming separate entities to clearly separate the income. For example, a law firm that leases part of its building to other professionals could form two entities—one to provide legal services and another to own and lease the real estate. This would delineate the sources of income. Even if the personal services income does not qualify for the QBI deduction, the rental income may still be eligible.

Conclusion

The reduced corporate income tax rate and new QBI deduction are the most significant tax reforms in more than 30 years. It creates unprecedented business tax planning opportunities for both individual and business clients. Even though the legal and tax community awaits further IRS guidance, now is the time to commence or continue work with clients on entity selection and tax minimization.