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New Deduction for Shareholders of S Corporations, Partners of Partnerships and Sole Proprietorships: Qualified Business Income Deduction (IRC § 199A)

Mar 20 2018

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Practice Area: Business and Corporate Law & Tax

The Tax Cuts and Jobs Act added a new deduction for noncorporate taxpayers for qualified business income. This new deduction (the "QBI Deduction") should provide a substantial benefit for shareholders of S corporations, partners of partnerships (which are not corporations) and sole proprietorships. Trusts and estates are also eligible for the deduction. The QBI Deduction is not allowed in computing adjusted gross income and is not treated as an itemized deduction. Instead, it is treated as a separate deduction in arriving at taxable income and can be used by non-itemizers and itemizers. Assuming all of an individual taxpayer's income for a taxable year is qualified business income, the QBI Deduction will reduce the maximum federal effective rate of tax from 37% to 29.6%. This new deduction is effective for taxable years beginning after December 31, 2017 and before January 1, 2026. Currently, the QBI deduction does not apply for Wisconsin income tax purposes. The QBI Deduction is intended to reduce the overall tax burden on flow through income in a manner proportionate to the reduction in the federal C corporation rate to 21%.

<u>General Rule</u>
In general, the QBI Deduction is 20% of the taxpayer's “qualified business income” from each “qualified trade or business.”

Qualified Business Income

In general, the QBI Deduction is 20% of the taxpayer's "qualified business income" from each "qualified trade or business." Qualified business income means domestic items of income, gain, deduction and loss from a qualified trade or business, but only to the extent included or allowed in the computation of taxable income for the taxable year. Qualified business income does not include investment items such as capital gains and losses, dividends, interest income (unless properly allocable to the trade or business), and certain other non-business items. Also excluded from the term qualified business income is reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business, guaranteed payments (described in IRC § 707(c)) paid to a partner and certain other payments to partners for services. Upon a sale of assets (direct, IRC §§ 338(h)(10) or 336(e)) ordinary items of income such as depreciation recapture, sales of inventory, cash basis receivables and income from assets which are not capital assets should be included in qualified business income. Gains from the sale of Section 1231 property may not be included in qualified business income but this is not clear. The Treasury is to provide rules for application of the QBI Deduction in cases of disposition of a qualified trade or business and certain other matters. The computation of the QBI deduction is adjusted for the taxpayer's allocable share of qualified cooperative dividends, qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year.

If the net amount of qualified business income from all qualified trades or businesses is a loss, the loss is carried forward as a loss from a qualified trade or business in the next taxable year. The owner's status as active or passive does not affect the QBI deduction. Each individual, shareholder or partner takes into account such persons' allocable share of each item relevant to the computation of the QBI deduction.

Qualified Trade or Business

A qualified trade or business means any trade or business other than the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal assets of such trade or business is the reputation or skill of one or more of its employees or owners. Also excluded are services that consist of investing and investment management, trading or dealing in certain securities, partnership interests or commodities. Where a taxpayer's taxable income for a taxable year is less than $315,000 (in case of a joint return) or $157,500 (for other filers), such otherwise excluded service business can still be treated as a qualified trade or business subject to certain computational rules in determining qualified business income. This rule is phased out over the next $100,000 (in case of a joint return) or $50,000 (for other filers). Thus, a partner in a partnership which provides legal or accounting services may obtain a QBI deduction where such partner's taxable income is within this threshold. Also the trade or business of performing services as an employee is not a qualified trade or business.

For example: John is a lawyer who files a joint return with his spouse. Their total taxable income is exclusively from John's law practice totaling $365,000. Since John is a lawyer, the income relating to practicing law will be taken into account only to the extent of the applicable percentage of those amounts; 50% ($50,000 = $365,000 - $315,000) / $100,000.

Limitations
There are limitations on the amount of the QBI deduction. The QBI deduction cannot exceed the greater of (i) 50% of the taxpayer's allocable share of the W-2 Wages for the qualified trade or business, or (ii) the sum of 25% of the taxpayer's allocable share of the W-2 wages for the qualified trade or business, plus 2.5% of the original cost of qualified property. W-2 wages means with respect to any person for any taxable year wages as defined in IRC § 6051(a)(3) and elective deferrals as defined in IRC § 6051(a)(8) paid by such person with respect to employment of employees by such person. The wages must be allocable to qualified business income. A partner or S corporation shareholder would take into account such partner's or shareholder's allocable share of the W-2 wages of the partnership or S corporation. Qualified property means with respect to any qualified trade or business tangible property subject to the allowance for depreciation under Section 167 which is used in the production of qualified business income and the depreciable period for which has not ended before the close of the taxable year. Land would not be qualified property but improvements on land would. This limitation does not apply to a taxpayer whose taxable income is less than $315,000 (in case of a joint return) or $157,500 (for other filers) and is phased out over the next $100,000 (in case of a joint return) or $50,000 (for other filers).

Also, the QBI deduction cannot exceed 20% of the taxable income of the taxpayer for the taxable year minus the sum of net capital gains. Obviously the complexities surrounding this new deduction can be formidable.

Example 1:

	Qualified Trade or Business 1	**Qualified Trade or Business 2**	**Total**
Qualified Business Income	500,000	(100,000)	400,000
W-2 Wages	250,000	25,000	225,000
Qualified Property	1,000,000	1,250,000	2,250,000
Taxable Income (less net capital gain)			700,000
Tentative QBI Deduction 20% of Qualified Business Income	100,000	(20,000)	80,000

Limitations

	Qualified Trade or Business 1	**Qualified Trade or Business 2**	
1. 50% of W-2 Wages	125,000	12,500	
2. 25% of W-2 Wages	62,500	6,250	

2.5% of Qualified Property	<u>25,000</u>	<u>31,250</u>	
	87,500	37,500	
3. Greater of Line 1 or Line 2	125,000	37,500	162,500
4. Lesser of the Tentative QBI Deduction or Line 3	100,000	(20,000)	80,000
5. 20% of taxable income (less net capital gain)			140,000

QBI deduction is $80,000 because the Tentative QBI Deduction for each Qualified Trade or Business is less than Line 3 for each Qualified Trade or Business and the total Tentative QBI Deduction is less than Line 5.

<u>Example 2:</u>

	Qualified Trade or Business 1	**Qualified Trade or Business 2**	**Total**
Qualified Business Income	500,000	200,000	700,000
W-2 Wages	100,000	25,000	125,000
Qualified Property	500,000	700,000	1,200,000
Taxable Income (less net capital gain)			600,000
Tentative QBI Deduction 20% of Qualified Business Income	100,000	40,000	140,000

<u>Limitations</u>

	Qualified Trade or Business 1	Qualified Trade or Business 2	
1. 50% of W-2 Wages	50,000	12,500	
2. 25% of W-2 Wages	25,000	6,250	
2.5% of Qualified Property	12,500	17,500	
	37,500	23,750	
3. Greater of Line 1 or Line 2	50,000	23,750	
4. Lesser of the Tentative QBI Deduction or Line 3	50,000	23,750	73,750
5. 20% of taxable income (less net capital gain)			120,000

QBI deduction is $73,750 because Line 3 for each Qualified Trade or Business is less than the Tentative QBI deduction for each Qualified Trade or Business and the total on Line 4 is less than Line 5.

Example 3:

	Qualified Trade or Business 1	Qualified Trade or Business 2	Total
Qualified Business Income	500,000	(600,000)	(100,000)
W-2 Wages	100,000	25,000	125,000
Qualified Property	500,000	700,000	1,200,000
Taxable Income (less net capital gain)[1]			200,000

Tentative QBI Deduction 20% of Qualified Business Income	100,000	(120,000)	(20,000)

Limitations

	Qualified Trade or Business 1	Qualified Trade or Business 2	
1. 50% of W-2 Wages	50,000	12,500	
2. 25% of W-2 Wages	25,000	6,250	
2.5% of Qualified Property	12,500	17,500	
	37,500	23,750	
3. Greater of Line 1 or Line 2	50,000	23,750	
4. Lesser of the Tentative QBI Deduction or Line 3	100,000	(120,000)	(20,000)
5. 20% of taxable income (less net capital gain)			40,000

QBI deduction is $0. The 20,000 net loss from all Qualified Trade or Businesses is carried over to the next taxable year and is treated as a loss from a qualified trade or business in that year. The Line 3 limitation does not apply because joint taxable income is less than $315,000.

Example 4:

	Qualified Trade or Business 1	Qualified Trade or Business 2	Total

Qualified Business Income	500,000	500,000	1,000,000
W-2 Wages	300,000	25,000	325,000
Qualified Property	500,000	700,000	1,200,000
Taxable Income (less net capital gain)			600,000
Tentative QBI Deduction 20% of Qualified Business Income	100,000	100,000	200,000

Limitations

	Qualified Trade or Business 1	**Qualified Trade or Business 2**	
1. 50% of W-2 Wages	150,000	12,500	
2. 25% of W-2 Wages	75,000	6,250	
2.5% of Qualified Property	12,500	17,500	
	87,500	23,750	
3. Greater of Line 1 or Line 2	150,000	23,750	
4. Lesser of the Tentative QBI Deduction or Line 3	100,000	23,750	123,750
5. 20% of taxable income (less net capital gain)			120,000

QBI deduction is $120,000 because Line 5 is less than the total of $123,750 on Line 4.

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[1] Assume this is taxable income on a joint return and there is no net capital gain.

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