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January 31, 2018

Re: Qualified Business Income Deduction under the Tax Cuts and Jobs Act

Dear Clients and Friends,

On December 22, 2017 the Tax Cuts and Jobs Act (the "Act) was signed into law. The new tax law creates numerous tax-saving opportunities for businesses of all shapes and sizes. Notably, the new law carves out a brand new tax deduction for owners of pass-through entities and sole proprietors. This letter addresses the Section 199A deduction for qualified business income of pass-through entities and sole proprietors.

Broad Overview

For tax years beginning after December 31, 2017, Code Section 199A has been added to allow a deduction equal to 20% of your "Qualified Business Income" (QBI) from a partnership, S corporation, or sole proprietorship. This income is sometimes referred to as "pass-through" income. The deduction is available to individuals, estates and trusts that own interests in these pass-through businesses. The deduction is subject to income level restrictions and phase outs. There is one major exception: The deduction is not available to C corporations.

QBI is best thought of as the ordinary, non-investment income of the business. QBI may include all kinds of business income, including income from services and income from real estate. However, it does not include W-2 income (even if the W-2 income is from a pass-through entity owned in whole or in part by the taxpayer) or partner guaranteed payments. Stated in another way, this is the revenue the business was designed to generate, less the applicable expenses. So, ignore things like interest or dividend income or capital gains from the sale of property.

However, there are limitations to the QBI deduction (QBID). As a starting point, the deduction is generally calculated as 20% of QBI. Any qualified owner with taxable income under $315,000 (for married filing jointly; $157,500, for other individuals), can take this deduction, assuming they have taxable income over $0. In general, the QBID also cannot exceed 20% of the excess of the taxpayer's taxable income over net capital gains.

The Act specifies that the deduction is *not* taken in computing adjusted gross income (it is not an above-line deduction) and that it is allowed to both itemizers and non-itemizers.

Therefore, it appears that the deduction will be taken after either the standard deduction or itemized deductions:

Adjusted gross income ....
Less: standard deduction or itemized deductions ....
Taxable income before IRC §199A deduction ....
Less: IRC §199A deduction ....
Taxable income ....

Furthermore, the deduction does not reduce net investment income (NII) or self-employment income.

If the net income of QBI is less than zero, the loss will be carried to the next taxable year and included in the calculation of QBI for that year.

Limitations on types of qualifying income - Specified Service Businesses

Specified service businesses (SSBs) are defined as any trade or business involving 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 asset of such trade or business is the reputation or skill of 1 or more of its employees. Operating an SSB limits your allowable QBID, when taxable income is over $315,000 ($157,500 for other individuals). A QBID is fully disallowed for owner/operated SSBs, when taxable income exceeds $415,000 ($207,500 for other individuals). Thus, taxpayers with taxable incomes above the upper ranges lose the deduction entirely. Taxpayers within the range lose the deduction in proportion to the excess of the taxable income over the initial phase-out amount to the total phase-out range.

Limitations based on wages and capital

Exceeding the phase-out levels for business income other than service businesses will not necessarily cause the taxpayer to lose the deduction. Instead, it will allow a deduction subject to other limitations. Specifically, if the taxpayer's taxable income exceeds the phase-out thresholds, the QBID looks at W-2 wages paid to employees and to the unadjusted basis of depreciable property held by the business. For these high-income taxpayers, the deduction is limited to the greater of:

- 50% of the W-2 wages paid by the business; or
- The sum of:
    - 25% of the W-2 wages paid by the business, plus
    - 2.5% of the unadjusted basis immediately after acquisition of depreciable property.

Rental real estate entities tend to have few, if any, employees. The capital component will help mitigate this situation.

Limitation on taxable income

After determining 20 percent of the combined business income for all trades or businesses (subject to the specified service trade or business limitation and the wage and basis limitations), one more limitation is based on taxable income. The deduction cannot exceed 20 percent of taxable income in excess of net capital gains. Net capital gain for this purpose includes capital gains and dividends that qualify for a favorable tax rate (such as the maximum 20 percent rate for capital gains).

Example of phase-outs for Non-Specified Service Businesses

Facts: Taxpayers D, E and F all operate manufacturing businesses, operating as sole proprietors. All are single. None have any capital gains. D has depreciable property, but no employees. E has employees, but rents her building and all her equipment. F has employees and depreciable property.

		D	E	F
(A)	Net qualifying business income	$ 400,000	$ 400,000	$ 400,000
(B)	Taxable income before QBID	400,000	400,000	400,000
(C)	lesser of (A) or (B)	400,000	400,000	400,000
	QBID (20% x (C))	80,000	**80,000**	80,000
	W-2 wages paid	-	300,000	100,000
	Unadjusted basis of depreciable assets	1,000,000	-	400,000
	50% of W-2s	-	150,000	**50,000**
	25% of W-2s + 2.5% of assets	**25,000**	75,000	35,000
	QBID	$ 25,000	$ 80,000	$ 50,000

Example of phase-outs for Specified Service Businesses

Facts: Taxpayers X, Y and Z are all lawyers, operating as sole proprietors. All are single. None have any capital gains.

		X	Y	Z
(A)	Net qualifying business income	$ 100,000	$ 200,000	$ 100,000
(B)	Taxable income before QBID	90,000	220,000	167,500
(C)	lesser of (A) or (B)	90,000	200,000	100,000
	QBID (20% x (C))	**18,000**	40,000	20,000
	Phase-Out	-	40,000	4,000
	QBID	$ 18,000	$ -	$ 16,000

Note:

* X is allowed the full deduction because his taxable income before the deduction is below the lower threshold of the phase-out range;
* Y's deduction is fully phased out because her taxable income before the deduction is over the upper end of the phase-out range;
* Z's deduction is partially phased out. Her taxable income is $100,000 over the initial range ($167,500-$157,500). The total phase-out range is $50,000 ($157,000-$207,500). Therefore, her phase-out is 20% of her initial deduction ($10,000/$50,000). Her phase-out is $4,000 (20%x$20,000)

Important considerations

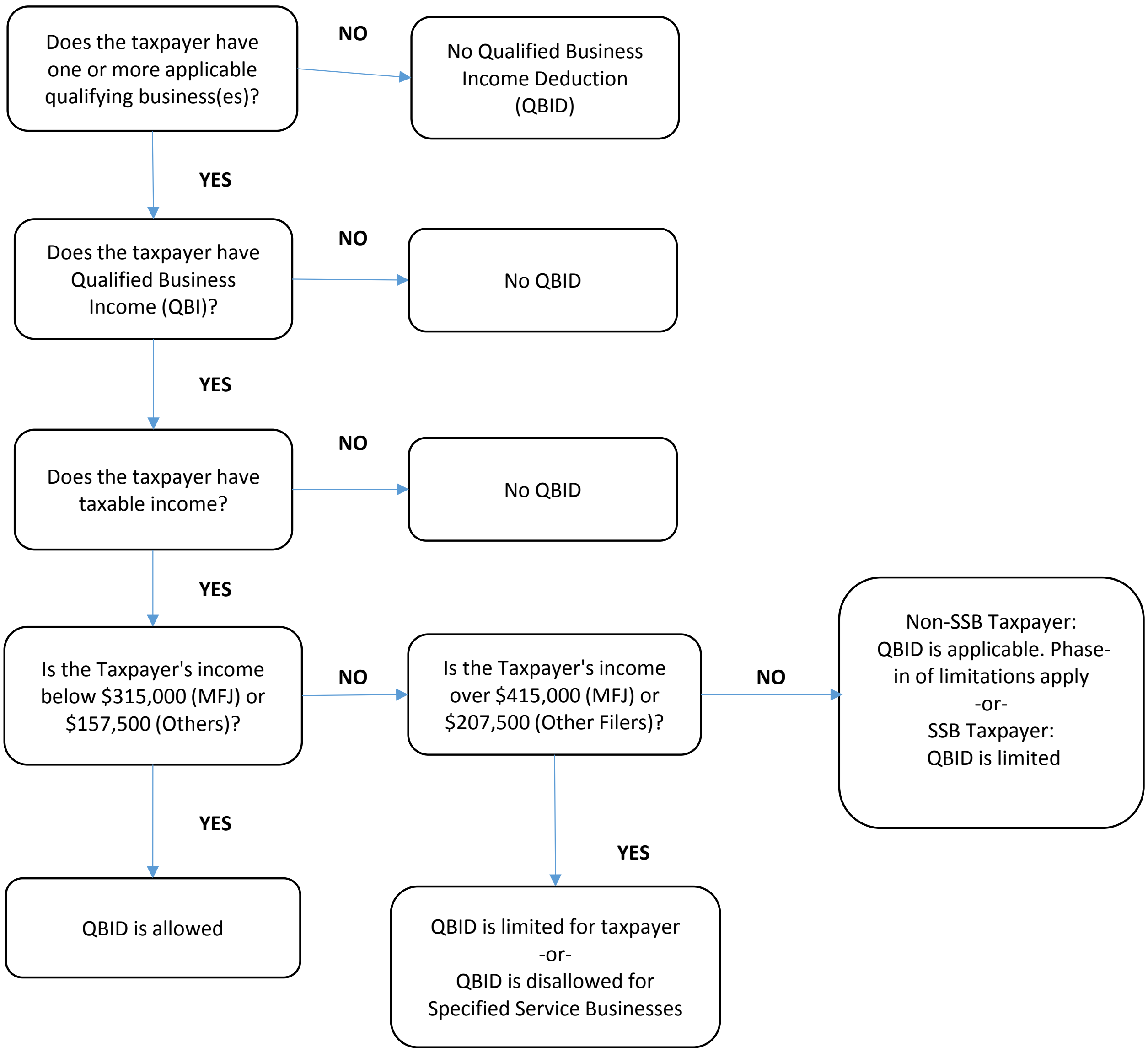
This new deduction can greatly impact your personal tax situation. In general, planning opportunities remain in understanding entity choice, business type, wages paid, and depreciable assets purchased. With this new deduction, converting/incorporating/organizing one pass through entity into another may or may not make sense. Having a strong understanding of your type of business, as an SSB or non SSB, could significantly alter your eligible QBID. Reviewing wages paid, year-end bonuses, payroll to owners, and the impact of payroll taxes, are all items to consider as they relate to adjusting your eligible QBID. Depreciable assets purchased, with increased depreciation deductions but potentially increased sales tax/property tax, also can impact your eligible QBID.

We have attached a decision tree to assist you on understanding if you are eligible for the QBID. There are many factors to consider, and maximizing any tax advantages does remain complicated. Therefore, contacting your tax professionals at Duffy Kruspodin, LLP, early in 2018, will be important to accurately understand and plan for your best possible taxable outcome.

Sincerely,

DUFFY KRUSPODIN, LLP

The following contributed to this article: Joshua J. Bodenstadt, Partner; Derek Hess, CPA; Geoffrey Pope, CPA


Does the taxpayer have one or more applicable qualifying business(es)?
NO
No Qualified Business Income Deduction (QBID)
YES
Does the taxpayer have Qualified Business Income (QBI)?
NO
No QBID
YES
Does the taxpayer have taxable income?
NO
No QBID
YES
Is the Taxpayer's income below $315,000 (MFJ) or $157,500 (Others)?
NO
Is the Taxpayer's income over $415,000 (MFJ) or $207,500 (Other Filers)?
NO
Non-SSB Taxpayer: QBID is applicable. Phase-in of limitations apply
-or-
SSB Taxpayer: QBID is limited
YES
QBID is allowed
YES
QBID is limited for taxpayer
-or-
QBID is disallowed for Specified Service Businesses