

Tax Cuts and Jobs Act: Qualified Business Income Deduction

Part 1



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The Tax Cuts and Jobs Act includes a new deduction for individual business owners who conduct their activities through a sole proprietorship, partnership, or S corporation. Trusts and estates are also eligible to claim the deduction. The deduction is effective for taxable years beginning after December 31, 2017, but continues only through taxable years beginning prior to December 31, 2025. In a series of three articles, we will discuss the new deduction, its complexities, and its uncertainties. (Please note that the discussion below is based on the statute and committee explanations and is subject to change with additional guidance.)

The qualified business income (QBI) deduction is a 20% deduction from the net taxable business income of each separate qualified trade or business of the taxpayer, regardless of whether the business is conducted as a sole proprietorship or through a pass-through entity, such as a partnership or S corporation. The deduction is applicable regardless of whether the taxpayer has an active or passive role (for example, as a limited partner) in the operation of the business. Additionally, the new law provides for a 20% deduction with respect to certain qualified income from real estate investment trusts (REITs) and publicly-traded partnerships (PTPs).

The 20% deduction for each separate trade or business is subject to certain limitations related to wages paid and depreciable property owned and used by the business. There is an additional limitation for the combined business income deduction for each separate trade or business and the deductions related to REIT and PTP income based on the taxable income of the individual taxpayer. After this limitation is applied, the deduction is increased if the taxpayer has qualified cooperative dividends.

Although the next article will cover in more detail the definition of a qualified trade or business and type of business income that qualifies for the deduction, it should be noted that based on the statutory language, most retail, manufacturing, and real estate businesses, and many service businesses, should qualify. However, certain service businesses will not qualify for the deduction if the owner's taxable income exceeds a certain amount.

As noted above, the qualified business income deduction is calculated separately for each qualified trade or business and then the combined amount is subject to the taxable income limitation. In determining the deduction for each separate business, the calculation begins with 20% of the net taxable business income of the business. This is the maximum deduction applicable to that business. There are special rules applicable to businesses with losses, which we will address later.

The next step is to determine the limitation based on the wages paid by the business and the depreciable property owned and used by the business. This limitation is only applicable if the owner's taxable income for the year exceeds a certain "threshold amount" for the taxable year. The threshold amount for 2018 is \$315,000 for taxpayers filing joint returns and \$157,500 for all other taxpayers. These amounts will be adjusted for inflation. The limitation is "phased-in" after taxable income exceeds these amounts and is fully applicable when taxable income exceeds \$415,000 and \$207,500, respectively.

Generally, the deduction for each separate business is limited to the greater of two amounts.

The first amount is 50% of the "W-2 wages" of the business. W-2 wages include wages paid by the business that are subject to withholding plus certain deferred wages, such as Section 401(k) contributions. So, for example, if a business had \$200,000 of wages paid including deferrals, this limitation amount would be \$100,000.

The second limitation amount is the sum of 25% of W-2 wages plus 2.5% of qualifying depreciable property owned and used by the business. The property generally must be real property or personal property that was acquired within the last 10 years. The 2.5% is applied to the original cost or basis of the property, rather than the remaining undepreciated cost. Assuming the business in the above example had \$1 million of qualifying property at the end of the tax year, this second limitation would be the sum of 25% of \$200,000 for the wage component plus 2.5% of \$1 million for the property component, or $\$50,000 + \$25,000 = \$75,000$.

Accordingly, the higher of the two limitation amounts is \$100,000, so the qualified business income deduction for this separate business would be limited to \$100,000, regardless of whether the 20% of business income was a higher amount. However, if the 20% amount is less than the limitation, say \$50,000 in this example, then the deduction is limited to the 20%, or \$50,000 in this example.

As noted above, the sum of the deductions for each separate trade or business, plus 20% of qualified REIT and PTP income, is limited by the taxable income of the owner (or owner and spouse if filing jointly). The combined deduction is limited to 20% of the taxable income in excess of capital gains and certain cooperative dividends. Although guidance has not been published, capital gains as defined in the legislation include capital gains from the sale of assets used in a business. The lower of these two amounts, plus 20% of certain cooperative income, is the final deductible amount on the tax return. The deduction cannot exceed taxable income for the year.

As noted above, there are special rules regarding losses at businesses that qualify for the new deduction. Generally, if a taxpayer has multiple businesses, a loss at one business will reduce the combined deduction for all other separate businesses with positive income for the tax year. Additionally, an overall loss for all businesses for the tax year will be carried over to the next tax year and reduce the deduction in the succeeding tax year.

In the next article, we will discuss the types of trades or businesses and the income that qualifies for the new deduction.

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