

GUIDEPOST

§199A - Qualified Business Income Deduction



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The Tax Cuts and Jobs Act of 2017 lowered the top C corporation tax rate from 35% to 21%. In order to provide a benefit to other “pass-through” business entities, the Tax Act included Internal Revenue Code (IRC) §199A, which provides a 20% deduction for qualified business income (QBI). The deduction lowers the effective rate at which certain income, earned by a non-corporate taxpayer, is taxed. The combination of this deduction and the new maximum individual tax rate of 37% results in a maximum effective tax rate on QBI of 29.6%.

The Deduction

The §199A QBI deduction is available to the owners of pass-through business entities, including S corporations, partnerships, sole proprietorships and LLCs taxed as such. Each owner is allocated his or her share of the deduction in accordance with his or her ownership in the business.

Qualified business income eligible for the deduction is income that:

- Is derived from a trade or business within the United States (and in some cases, Puerto Rico),
- Does not constitute either reasonable compensation paid to the taxpayer for services rendered with respect to the business, or guaranteed payments made to a partner for services provided to the partnership, and
- Does not constitute the following:
 - Capital gain or capital loss (whether long-term or short-term),
 - Dividend (or similar) income,
 - Interest income (other than interest income properly allocable to a trade or business),
 - Items relating to certain transactions in commodities, foreign currencies or notional principal contracts, or
 - A deduction or loss properly allocable to the foregoing.

Specified Service Trade or Business

All taxpayers with total reportable income below the thresholds (discussed below) are eligible to claim the §199A deduction with respect to their business. However, once the thresholds have been exceeded, QBI does not generally include income from a “specified service trade or business.” A specified service trade or business is defined as any business in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing, investment management, trading or dealing in securities, partnership interests or commodities.

Additionally, income from a trade or business where the principal asset of the trade or business is the reputation or skill of one or more of its owners or employees is also excluded. Note that architectural and engineering services are specifically excluded from the definition of a specified service business.

Who Can Claim the Deduction?

The deduction is available to all taxpayers other than C corporations. Therefore, individuals, and trusts and estates that report QBI, can claim the deduction. This includes sole proprietors who report their income on Schedule C, as well as taxpayers with income from pass-through entities, such as S corporations, partnerships and limited liability companies that report their income and loss to their owners on Schedule K-1.

Calculating the Deduction

The starting point of the computation is the calculation of the net business income for each of the taxpayer’s qualified business as defined above. The net income of each business is then multiplied by 20 percent. This 20 percent is then compared against several alternative limitations, namely:

- 50% of wages,
- the sum of 25% of wages and 2.5% and the unadjusted (i.e., original) cost basis of depreciable property owned and used by the business (discussed in more detail below), and
- 20% of the taxpayer's taxable income reduced by net capital gains.

The lesser amount based on the above determination is then added to 20% of the taxpayer's qualified REIT dividends, and qualified publicly traded partnership income.

If the total of all of the owner's QBI from all sources results in a loss, the loss carries forward indefinitely and reduces qualified business income in subsequent years.

Threshold Amounts

The full 20% deduction is available to all eligible taxpayers (business owners who report QBI), who report income below certain threshold amounts, without regard to the wage and basis limitations or the specified service business rules.

Married taxpayers who file jointly can take the full deduction if they report taxable income, from all sources, of less than \$321,400. Married taxpayers who file separately can take the full deduction if their taxable income is less than \$160,725, and all other taxpayers can take the full deduction if their taxable income is less than \$160,700. On a joint return, the benefit obtained from this exclusion is phased out between \$321,400 and \$421,400 of taxable income; for married taxpayers filing separately, the deduction is phased out between \$160,725 and \$210,725; and for single and head of household filers, the benefit is phased out between \$160,700 and \$210,700 of taxable income.

Limitations

For purposes of the above limits, W-2 wages are defined as wages paid to an employee, including any elective deferrals paid into compensation plans. W-2 wages do not include payments to independent contractors or management fees.

The unadjusted basis of depreciable property is determined "immediately after acquisition." This includes the purchase price and related capitalized costs before the asset's basis is subsequently reduced by depreciation deductions. For purposes of calculating this limitation, only assets that have not been fully depreciated can be taken into account, and the depreciable life of an item will be the greater of its depreciable life determined under IRC §168 or 10 years.

The 50% W-2 wage limit and the 25% W-2 wage and 2.5% depreciable property limitation do not apply to the deduction for REIT dividends, income from publicly traded partnerships, and agricultural and horticultural co-ops.

Lastly, an individual's total deduction under §199A for any taxable year is generally capped at an amount equal to 20% of the excess (if any) their taxable income from all sources for the year minus any net capital gain for the year.

Examples

Example 1: Al is married and owns a construction company. He and his wife, Peg, have total taxable income of \$300,000, \$200,000 of which is QBI income from the construction company. Al pays total W-2 wages of \$50,000.

Because Al and Peg make under \$321,400, they are not subject to the W-2 wage and/or depreciable property limitations and are eligible to take a 20% deduction against the \$200,000 of QBI, or \$40,000. As a result, they will pay taxes on \$260,000 of taxable income. As their marginal tax rate is 24%, they will save \$9,600 in taxes.

Example 2: The facts are the same as in Example 1, except Al owns an accounting practice.

The answer is the same as in Example 1. Because Al and Peg make under \$321,400, Al's QBI is not subject to the specified services limitation and they will be able to take the same deduction as above.

Example 3: The facts are the same as in Example 1, except Al and Peg report taxable income of \$500,000 and QBI of \$300,000. Al pays W-2 wages of \$100,000 and the company has depreciable assets with an unadjusted basis of \$300,000.

Because Al and Peg report income in excess of \$421,400, the deduction will be limited to the lesser of the following:

- 20% of QBI (\$300,000) or \$60,000;
- Or the greater of:
 - 50% of wages (\$100,000)— \$50,000; or
 - 25% of wages (\$100,000) and 2.5 percent of the unadjusted basis of the company's assets (\$300,000)— \$25,000 plus \$7,500 for a total of \$32,500.

The amount of the deduction will be limited to \$50,000. They will therefore pay taxes on \$450,000. Their marginal tax rate is 35%, resulting in tax savings of \$17,500.

Example 4: The facts are the same as in Example 3, except Al is operating an accounting practice.

Because Al operates an accounting practice, a specified trade or business, and he and Peg report taxable income in excess of \$421,400, he is not eligible to take the deduction. They will therefore pay income taxes on their full taxable income of \$500,000.



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