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QUALIFIED BUSINESS INCOME (Tax Topic #6)

New Tax Laws and What it Means for Your Business

The Tax Cuts and Jobs Act created a 20% tax deduction for owners of S corporations, partnerships, LLCs, sole proprietorships and farms against their qualified business income, subject to a number of limitations. A few highlights of the new provision, technically called the Section 199A deduction is discussed below. Please be aware that this provision will expire on Dec. 31, 2025.

Beginning in 2018, individual taxpayers may deduct up to 20% of domestic qualified business income (QBI) from your S corporation, partnership, LLC, sole proprietorship or farm. In some situations, net rental income may qualify for some or all of the 20% QBI deduction. Limitations apply based on wages paid or if the qualified business income is from a specified service business (like consulting, law, accounting, medical, financial services, etc.)

Qualified business income (QBI). QBI is the net income of your Schedule C, S corporation, partnership, LLC, sole proprietor, partnership, farm and rental property. These are often referred to as "passthrough income," only meaning that the income from these various business structures is reported on your individual tax return. Capital gains from the sale of a business asset is not included. Interest and dividend income on business accounts is not included.

If you have a sole proprietorship that makes money and an LLC that loses money, the two are netted on your individual return in calculating the 20% QBI deduction. If these two businesses are a net loss, the loss carries over to the next year and reduces qualified business income in that year.

Taxable income threshold. The wage and specified personal service business limitations do not apply if your Form 1040 taxable income is less than $157,500 ($315,000 for a married filing joint couple.) The deduction phases out for taxable income between $157,500 and $207,500 (between $315,000 and $415,000 for a married filing joint couple.)

> **What does this mean?** If your net schedule C income or the K-1 income from your business operating as an S corporation or LLC is $100,000 and you're single with taxable income below $157,500, you can qualify for a new $20,000 deduction.

Wage limitation — general. If taxable income exceeds the threshold numbers (see paragraph above), the 20% QBI deduction cannot exceed 50% of the W-2 wages of the business.

What does this mean? If your net schedule C income or the K-1 income from your business operating as an S corporation or LLC is $500,000 and your taxable income exceeds the thresholds, your company must pay wages to qualify for the new 20% QBI deduction. If your company pays $150,000 of wages, instead of a $100,000 deduction (20% of $500,000), you are limited to a $75,000 deduction (50% of $150,000 wage).

Wage limitation exception — capital intensive business and rental property. If taxable income exceeds the threshold numbers, the 20% QBI deduction cannot exceed 50% of the W-2 wages of the business OR 25% of wages plus 2.5% of the unadjusted basis of depreciable assets used in the business.

What does this mean? Your net schedule C income or the K-1 income from your business operating as an S corporation or LLC is $500,000 and your taxable income exceeds the thresholds. Your business pays no wages. Because the business doesn't pay wages, you don't qualify for the 20% QBI deduction except for this next rule. Your business uses machinery and trucks with an unadjusted basis of $300,000. While you don't qualify for the $100,000 deduction (20% of $500,000 net business income), you do qualify for a $7,500 deduction based on 2.5% of the $300,000 of equipment the business uses.

The reduced deduction doesn't look very good in the example above but see how the limitation works on rental property. Your net rental income is $100,000 and your taxable income exceeds the threshold. Your property is managed and, thus, you pay no wages for the rental property. Because you pay no wages, your $20,000 deduction (20% of the $100,000 net rental income) is limited to 2.5% of the unadjusted basis of the rental property (not including land). If the unadjusted basis of the rental property is $700,000, you qualify to claim a $17,500 deduction against your rental income.

Specified service business limitation. If taxable income exceeds the threshold numbers, and your business income is from a specified service business, you do not qualify for the new 20% QBI deduction. A specified service business is any trade or business involving the performance of services in the fields of consulting, health, law, accounting, actuarial science, performing arts, athletics, financial services, brokerage services, including investing and investment management, trading, or dealing in securities, partnership interests, or commodities. Specified service businesses also include 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. This provision is not defined in the new tax reform law. The IRS will be responsible for providing definitions and examples.

What does this mean? You report net schedule C income or the K-1 income from your specified service business (you are a consultant, doctor, lawyer, broker, actor or athlete, for example) operating as an S corporation or an LLC on your Form 1040. If your taxable income exceeds the thresholds, you are not entitled to the new 20% QBI business income deduction, as your income is not "qualified".

State impact. California and several other states do not automatically conform to the Federal tax changes. There is no 20% QBI deduction for the calculation of California taxable income.

Summary. This is the briefest explanation of the most complicated part of the new tax reform law. Please call our office for advice regarding your specific business and your personal tax situation.