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The New Qualified Business Income: An Overview

Beginning in 2018, taxpayers can deduct up to 20% of their income from pass-through entities such as S corporations and partnerships with certain limitations. The new qualified business income (QBI) deduction provides shareholders and partners of pass-through entities with a tax rate reduction similar to what C corporations now receive under the *Tax Cuts & Jobs Act* (TCJA).

For tax years beginning January 1, 2018, or later, the TCJA has repealed the domestic production activities deduction (DPAD), an approximately 9% deduction unique to construction and other select industries. Consequently, contractors see an increase from the previous 9% with specific limitations under DPAD to a potential 20% with the QBI deduction,[1] with similar and different limitations.

While certain policy decisions related to the new deduction may still be adjusted, the proposed regulations[2] clarify many issues and raise others. This article will offer an overview of the new deduction and explore considerations for companies going forward.

Qualifying Business & Service Businesses

Unlike DPAD, which applied to corporate taxpayers and pass-through entities primarily in the construction and manufacturing industries, the QBI deduction is available to all non-corporate taxpayers[3] engaged in "any trade or business other than a specified service trade or business" under Section 162.[4]

The reference to Section 162 is important for most industries due to the considerable history of cases defining what qualifies as a "trade or business." For related multiple entities holding real estate, there is not a clear result from the Section 162 lines of cases.

Although it's beyond the scope of this article, it is important to note that the QBI deduction also applies to real estate investment trust (REIT) dividends and publicly traded partnership (PTP) income.[5]

What Income Qualifies for the QBI Deduction?

The QBI deduction applies to "qualified business income,"[6] which is defined as "items of income, gain, deduction, and loss [that] are effectively connected with the conduct of a trade or business within the United States."[7]

This affects contractors differently than the DPAD previously had, as the QBI deduction is *not* reduced for the proportion of revenues representing construction services such as service or repair revenue (i.e., activities under the DPAD regulations that are not directly related to the erection or substantial renovation of real property).[8]

However, certain non-ordinary income (i.e., capital gains and dividends) that is not properly allocable to a qualified business[9] is excluded because it is generally taxed at lower marginal rates. Further, income not related to the qualified trade or business (i.e, certain interest income) is also excluded from QBI.

For example, capital gains and qualified dividends are taxed at more favorable capital gains rates from zero to 20% (or 23.8% when, in many cases, the 3.8% surtax on investment income applies). This compares to the new ordinary income tax rates that reach 37% for individuals.

How Is the QBI Deduction Calculated?

The QBI deduction provides a deduction for 20% of qualified income that is subject to several limitations. The following scenarios will illustrate how deductions can be calculated across different circumstances.

Scenario 1

Consider a taxpayer's qualified taxable income, which is reduced by the net capital gain.[10] For example, Contractor X, with $150,000 of taxable income, $20,000 of which is capital gain, would be limited to, at most, a QBI deduction of $26,000 (20% x [$150,000 taxable income – $20,000 capital gain]).

Second, a taxpayer's QBI deduction is further limited to the greater of:

1) 50% of the qualified business' W-2 wages; or

2) The sum of:

a) 25% of the qualified business' W-2 wages *plus*

b) 2.5% of the taxpayer's unadjusted basis immediately after acquisition of all qualified property (generally, the cost of fixed assets).[11]

The option to use Form W-2 wages ***plus*** the unadjusted basis in property may enable certain businesses to qualify for the new QBI deduction, even though they generally do not have Form W-2 wages.

Scenario 2

Consider a real estate rental business without Form W-2 wages that can use the cost of the rental property to calculate its QBI deduction limitation.

Pass-Through Entity A, which purchased a shopping plaza for $5 million, would be able to take a QBI deduction of no more than 2.5% of the cost of the unadjusted property basis, or $125,000 (2.5% times $5 million, which is assumed to be 100% depreciable for this example).

Returning to Scenario 1, Contractor X with $150,000 of taxable income (and $20,000 of capital gains) from his S corporation has an allocable share of $60,000 of Form W-2 wages. Additionally, his unadjusted basis in the business' property immediately after acquisition of such assets is $50,000.

Contractor X's QBI deduction is limited to the greater of:

1) 50% of W-2 wages, $30,000 ($60,000 times 50%), or

2) Sum of:

a) 25% of Form W-2 wages ($60,000 time 25% equals $15,000) ***plus***

b) 2.5% of his unadjusted basis in the business' property ($50,000 times 2.5% equals $1,250), or $16,250 ($15,000 plus $1,650).

Since the first value is greater, the secondary QBI deduction limitation is equal to $30,000. However, Section 199A requires taxpayers to use the lesser of the two limitations (20% of taxable income or the $30,000 from the secondary computation),[12] so the QBI deduction in this example is capped at $26,000 ($150,000 taxable income less $20,000 cap gains, or $130,000 times 20%).

Specified Service Trade or Businesses

The proposed regulations list 13 specified service trade or business (SSTB) fields that do not qualify for the QBI deduction including health care, law, accounting, financial services, consulting, and any business dependent upon the reputation or skill of an employee or owner.[13]

The plain language of the new Code Section 199A leaves some speculation regarding which businesses would fall under the umbrella of the latter two specified groups, and therefore, would not be entitled to the new QBI deduction. The proposed regulations define consulting businesses for QBI purposes and what is meant by "dependent upon the reputation of an employee or owner."

"Consulting," as defined for the QBI deduction, is the service of providing professional advice and counsel to clients "in achieving goals and solving problems."[14] The regulations specifically include governmental lobbying as a consulting service and exclude advising as a means of providing sales, training, or other similar educational courses.

It appears clear from the proposed regulations that certain construction-related businesses, such as construction management, real estate rental, and real estate management businesses, will qualify for the QBI deduction as they do not fall within the regulatory definition of consulting.

Regardless, contractors serving as owner representatives or providing construction management services should consult with their tax advisor as to whether they fall within the definition of consulting for QBI purposes.

The last business type on the list of SSTBs in the Code appears to be a "catch-all," as it details a broad category of businesses whose primary asset is the reputation or skill of its employees or owners, which appears to include most service businesses (i.e., customers generally hire a professional or buy a product based upon a firm or brand's reputation).

The proposed regulations narrow the definition of this catch-all to those businesses based on product endorsements or those instances in which a person licenses their name, image, signature, voice, etc.[15]

It is therefore inferred that a contractor's service operations (i.e., HVAC or electrical) with an established reputation will qualify for the QBI deduction, regardless if customers hire the company based primarily on an individual's reputation.

There is an exemption to the SSTB limitation based on the level of taxable income. A taxpayer engaged in one of the

SSTBs may still claim the QBI deduction if taxable income is below certain thresholds: $157,500 for an individual filer and $315,000 for joint filers.[16] These thresholds are phased out over the next $50,000 for individuals and $100,000 for joint filers. Thus, at $207,500 ($157,500 plus $50,000) of taxable income, individuals no longer receive any QBI deduction for their SSTB income. The threshold is $415,000 ($315,000 plus $100,000) for joint filers.

Mixed Revenue Streams

Businesses with mixed revenue streams from their qualified trade or business may also include specified service trades. The guidance reflects that services (e.g., consulting) that are sold as an ancillary aspect of a single contract can be ignored, provided that the combination of the qualified business and the ancillary services satisfy certain *de minimis* thresholds.

The proposed regulations establish differing *de minimis* thresholds based on the total revenue for the business at $25 million:

1) First, those businesses with gross receipts of $25 million or less who have less than 10% of gross receipts from an SSTB will qualify for the QBI deduction.[17]

2) That 10% of gross receipts threshold is reduced to 5% of gross receipts for businesses with total gross receipts of more than $25 million.[18]

The result, as the regulations currently read, is that businesses that fail the *de minimis* threshold will not qualify for a QBI deduction.

For example, consider two qualified pass-through entities with each reporting more than $25 million in revenue, where the first has SSTB activities representing 4% of its gross receipts. This pass-through entity will receive a QBI deduction for all of its business activities. Contrast that with a similar pass-through entity where 6% of its business activities are attributable to SSTB activities. This second pass-through entity will fail to report any QBI deduction because of the 5% "cliff cutoff" threshold under the proposed regulations. The same cliff cutoff applies at 10% if the entity's revenues are under $25 million.

This is an area in which there should be significant commentary to the proposed regulations. Practitioners should request that IRS change the regulations from a cliff cutoff to a percentage reduction; that is, if 6% of its business activities are attributable to SSTB activities, then the QBI deduction would be reduced to 94% and not to zero.

This cliff cutoff is a significant concern and causing companies to strategize how to avoid falling off this cliff. If it was a matter of losing a couple percentage points, it would not be such a huge concern to those companies who are seeking to restructure, divest, merge, re-evaluate the definitions of "trade or business", etc., to avoid the cliff and resulting complete loss of the 20% QBI deduction.

Independent Contractors & Employment Status

Independent contractor vs. employee status may impact whether one qualifies for the new QBI deduction; the IRS foresees potential complications about this issue. Because the QBI deduction does not extend to the business of performing services as an employee,[19] the proposed regulations address potential abuse by treating employees who shifted to independent contractor status as employees if they continue to provide substantially the same services as before their reclassification.[20]

Owner's Compensation

When computing QBI at the taxpayer level, S corporation shareholders must exclude their reasonable compensation paid from the business to themselves, and partners or members of partnerships must similarly exclude guaranteed payments or payments for services to the partnership.[21]

For the typical S corporation shareholder, this means that QBI is computed after the owner/shareholders' compensation. Depending on income levels and whether SSTBs are involved, this could mean varying results when an S corporation's shareholders are compared to partners in partnerships or sole proprietors. In short, nuances in the law and proposed regulations can cause similarly situated taxpayers to face differing results solely because of the type of entity in which they are doing business.

Multiple QBI Entities

Section 199A includes rules permitting taxpayers to aggregate QBI from multiple qualified businesses. Doing so could allow a taxpayer to claim a greater deduction based on higher Form W-2 wages or property limitations. In order to combine QBI, generally a taxpayer must own 50% or more of each business and must satisfy at least two of the following three requirements:

1) The businesses provide products or services that are traditionally offered together;

2) The businesses share significant business elements, such as buildings, personnel, technology, etc.; or

3) The businesses operate with a reliance upon each other.[22]

In making the decision to aggregate, which is permitted but not required,[23] a taxpayer must combine QBI, Form W-2 wages, and property basis consistently in all future years unless a material change in circumstances dictates otherwise.[24]

Business Losses

Affecting the QBI deduction are those years when the business produces negative QBI. The negative QBI reduces QBI from other business activities (in other entities), but any aggregate net unused negative QBI must be carried forward to the following year.[25]

For example, if Contractor A has more than one pass-through entity flowing to his personal return and the entities produce a net aggregate negative QBI, then the excess is carried forward; there is no current year benefit. The net aggregate negative carryover is tracked and offsets future net aggregate QBI in the following year or years.

Form W-2 Wages

As with other issues, the question of what qualifies as Form W-2 wages should be considered. The proposed regulations clarify that Form W-2 wages include all wages subject to federal income tax withholding, as well as elective deferrals and deferred compensation paid by a business.

Additionally, while the wages must be reported on the employees' Forms W-2 (and the employer's Form W-3), businesses that utilize a professional employment organization or third-party payroll service should include the wages properly allocable to their business, assuming the workers are the common law employees of the pass-through entity.

The IRS has provided guidance for calculating Form W-2 wages with respect to the corresponding boxes on Forms W-2.[26] These categories are familiar to contractors as they are substantially the same as the Form W-2 rules under the DPAD[27]:

1) Unmodified box method: the lesser of box 1 or box 5;

2) Modified box method: the total of the amounts in boxes 1 and 12 that are properly coded as D, E, F, G, and S, less any amounts that are included in box 1 but are not technically considered wages for Federal income tax withholding purposes; or

3) Tracking wages method: the total of the amounts in boxes 1 and 12 that are properly coded as D, E, F, G, and S.

As a tax planning strategy, businesses such as LLCs taxed as partnerships may consider Form W-2 wages as a possible alternative where permissible to guaranteed payments. This is because the guaranteed payments reduce the qualified business income available for the deduction, but do not increase the W-2 wages.

Where to Report

The QBI deduction is an offset that does not decrease the individual taxpayer's adjusted gross income (AGI) and does not increase itemized deductions. By not reducing AGI, the new deduction does not impact other tax return computations based on a percentage of AGI or the AGI as a threshold.

For example, taxpayers with higher AGI levels do not qualify for certain tax credits, including the child credit. In addition, certain itemized deductions such as medical expenses are reduced by a percentage of AGI. Because the new deduction is not part of itemized deductions, all qualifying taxpayers, including those who do not itemize, can benefit.

Other Issues

Many other areas of uncertainty and concern for contractors and practitioners require further scrutiny and clarity, including:

1) The new deduction will not affect tax basis for shareholders of an S corporation or partners in a partnership.[28]

2) The new deduction is not intended to affect the alternative minimum tax, self-employment tax, and the investment income surtax.[29]

3) Taxpayers may face underpayment penalty issues if they do not carefully consider the impact of the new QBI deduction.[30]

4) Fixed asset tracking and maintenance of adequate schedules for this new purpose can be an issue if the 2.5% unadjusted basis computations (for the second limitation listed here) are necessary to elevate the QBI deduction.

5) There are concerns and issues as to the impact of Section 1231 gains and losses on the sale of business equipment and property and its impact on the new QBI deduction.[31]

6) Maintaining another set of carry-over schedules (i.e., for excess QBI losses), will add to practitioners' compliance considerations. Moreover, the election of entities that can be grouped together for QBI purposes differs from the passive activity rules.[32] As a result, practitioners will need to track multiple sets of grouped entities.

Summary

While the QBI deduction under the new IRC Section 199A will benefit pass-through businesses that may be able to deduct up to 20% of QBI, there are many complex issues, calculations, limitations, and definitions to consider. Contractors and CFMs should consult a tax advisor who has a thorough understanding of the new law as to how the proposed regulations apply to their respective circumstances. ■

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Endnotes

1. IRC §199A.
2. Prop Reg §§ 1.199A-0 thru 1.199A-6.
3. IRC §199A(a).
4. Prop Reg §1.199A-1(b)(13); also see IRC §199A(g) for treatment of certain cooperatives.
5. IRC §199A(b)(1)(B).
6. IRC §199A(a)(1).
7. IRC §199A(c)(3)(A).
8. Reg. §1.199-3(m).
9. IRC §199A(c)(3)(B).
10. IRC §199A(a)(2)(B).
11. IRC §199A(b)(2)(B).
12. IRC §199A(b)(2).
13. Prop Reg § 1.199A-5(b)(1).
14. Prop Reg §1.199A-5(b)(2)(vii).
15. Prop Reg §1.199A-5(b)(2)(xiv).
16. IRC §199A(e)(2).
17. Prop Reg 1.199A-5(c)(1)(i).
18. Prop Reg 1.199A-5(c)(1)(ii).
19. Prop Reg 1.199A-5(d)(1).
20. Prop Reg §1.199A-5(d)(3)(i).
21. IRC §199A(c)(4).
22. Prop Reg §1.199A-4(b).
23. Prop Reg §1.199A-4(a).
24. Prop Reg §1.199A-4(c).
25. IRC §199A(c)(2).
26. *www.irs.gov/pub/irs-drop/n-18-64.pdf.*
27. *www.irs.gov/irb/2006-47_IRB.*
28. Prop Reg §1.199A-1(e)(1).
29. Prop Reg §1.199A-1(e)(2) & (4).
30. Prop Reg §1.199A-1(e)(5).
31. Prop Reg §1.199A-3(b)(2)(ii)(A).
32. Preamble to Prop Regs §1.199A-4 Explanation of Provisions at Section IV. A.

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