2018 Tax Reform: The Biggest Impact on U.S. Businesses Is the QBI Deduction

By Stephen Slade*

Stephen Slade examines the Code Sec. 199A qualified business income (QBI) deduction impact on business owners.

2019 regulation updates by the IRS and new tax laws passed by Congress represent the most substantive tax law changes since 1986. And, of all the tax law changes made in the past year, the Code Sec. 199A qualified business income (QBI) deduction has the biggest potential impact on business owners over the next eight years. The 20% QBI deduction is a brand-new concept that Congress created, and it is like nothing we've ever seen before. The final IRS regulations were issued on January 18, 2019, and the late timing had tax software companies scrambling to update their software packages as tax season commenced.

What Is the QBI Deduction?

The QBI deduction is a 20% deduction that can be used by owners of partnerships, S corporations, sole proprietorships and trust entities—just about any business entity other than a C corporation. The deduction is 20% of a taxpayer's QBI subject to numerous limitations and phase outs. For example, a taxpayer with $1 million of QBI could receive a free tax deduction of up to $200,000.

QBI must be domestically earned ordinary business income related to a trade or business. It excludes most types of investment income, but allows for rental and royalty income.

QBI must be reduced by the reasonable W-2 compensation paid to an S corporation owner or the guaranteed payments paid to a partner in a partnership. So, if you are a business that makes $100,000/year and you pay the owner a $50,000 W-2, your QBI will be $50,000 because you must reduce what you pay yourself.

The QBI deduction is taken at the shareholder 1040 level and it is allowed for alternative minimum tax purposes. It is up to the individual taxpayer to

STEPHEN SLADE is a Tax Director of Philadelphia-based CPA firm Wouch Maloney & Co., LLP.

determine the QBI deduction for each separate business they own, and they must combine the results from the various businesses to determine the net QBI income. If the taxpayer has an overall QBI loss, the amount must be carried forward to the next year.

IRS final regulations clarified that partnership owners and sole proprietors must reduce QBI income by deductions for self-employment tax, self-employed health insurance and contributions to qualified retirement plans in order to level the playing field with S corporation shareholders.

General QBI Limitations

There are limitations to the availability of the QBI deduction depending upon the type of business. If you own a specified service business, are married and file jointly and earn more than $415,000 in taxable income, you do not qualify for the 20% QBI deduction. Specified service business owners who are single or are married and filing separately and earn more than $207,500 do not qualify for the deduction.

And, of all the tax law changes made in the past year, the Code Sec. 199A qualified business income (QBI) deduction has the biggest potential impact on business owners over the next eight years.

If your business is not a specified service business, the W-2 limitation is similar to the earnings threshold for specified service businesses. If you are married and filing jointly and have taxable income between $315,000 and $415,000, you must demonstrate that your business has paid enough W-2 wages in order to fully take advantage of the QBI deduction. For example, if you own an S corporation, have taxable income of $500,000 and pay no wages, you can't get the deduction. If, however, you do pay sufficient W-2 wages, you'll be able to fully maximize the 20% deduction. The new law also provides for an optional determination where a business owner with minimal wages can rely on the unadjusted basis of depreciable property used in that trade or business to support a QBI deduction.

If you have a significant amount of long-term gain income, it could also limit your QBI deduction.

Specified Service Businesses

Since I have talked about specified services businesses, it may be helpful to share the IRS's definition of such a business. It is defined as any trade or business involving the performance of services in the fields of health (*e.g.*, physicians, dentists, nursing), legal, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services (*e.g.*, investing and investment management, trading or dealing in securities, partnership interests or commodities). Architects, engineers, insurance salespersons and real estate property managers are deemed not to be specified service businesses.

And, it is the business entity itself that must determine if it is a specified service business and report that determination to the IRS and on a Schedule K-1 to their investors. This determination is not made at the 1040 level unless you are a sole proprietor.

Consulting Businesses

One more aspect of the QBI deduction I believe would be worth detailing is the IRS's clarification of the definition of a consulting business entity. The IRS defines a consultant as one who provides professional advice and counsel to clients to assist the client in achieving goals and solving problems. It does not include the performance of services other than advice and counsel, such as the provision of training and educational courses. It also does not include consulting that is embedded in, or ancillary to, the sale of goods or the performance of services if there is no separate payment for the consulting services.

General QBI Deduction Considerations

- Be cognizant of your taxable income and the QBI limitations. There could be instances in which filing separate returns could maximize QBI. If you are married and the lower-earning spouse is the business owner and they have under $207,500 of taxable income, it may make sense to file separate returns.
- Keep in mind that the W-2 wages or guaranteed payments paid to owners could have a direct impact on the calculation of the QBI deduction. In some instances, the W-2 wages paid to an S corporation

shareholder can maximize the deduction, while in other instances the wages can reduce the QBI deduction. You need to understand how the owner's compensation impacts the deduction.

- You should carefully determine whether or not you are a specified service business. If you are, you run the risk of earning over the maximum allowed threshold and you would no longer qualify for the deduction.
- Be aware that the IRS has employed several blocking rules. For example, if you are a taxpayer that has multiple businesses in one entity and 10% or more of your gross receipts are attributable to specified services, the classification of your entire business may be as a specified service. The IRS's view is that if you have multiple businesses within an entity, you may be permitted to report separate QBI attributes on each business. However, you have to maintain a complete and separable set of books.
- The IRS allowed for some aggregation rules that are available only to non-service businesses. Assuming you meet several qualifications, if you own multiple businesses, you will be allowed to utilize W-2 wages from one business across multiple businesses, potentially maximizing your QBI deduction. This was very generous of the IRS since this concept did not appear in the law drafted by Congress.
- In an unexpected move, the IRS final regulations do not permit aggregation of commercial and residential rental businesses.
- Lastly, for business owners who own rental real estate properties, the IRS has developed a Rental Real Estate Safe Harbor Rule allowing the owners to claim that their real estate enterprise rises to the level of a trade or business, thus qualifying for the QBI deduction. To satisfy this safe harbor you must demonstrate the following:
  - Spend at least 250 hours annually maintaining or managing the properties;
  - Keep separate books and records for the properties;
  - The properties are not subject to triple-net-leases or any personal use (*i.e.*, vacation properties);
  - If you satisfy the Safe Harbor Rules and attach a signed affidavit with your tax return, you can receive IRS audit protection.

Conclusion

In summary, the QBI deduction is the single tax law change that will impact business owners most over the next eight years. But, there are many other changes that will impact owners, too, and my advice is that you make sure your tax advisor understands the new rules and understands your personal tax situation.

ENDNOTE

* The author has 17 years of experience providing tax and consulting services to business and individual clients. Stephen is responsible for creating the firm's tax policy and ensuring that all staff are properly informed of the ever-changing tax laws. His experience involves all areas of taxation with a specialization in closely held businesses, high net worth taxpayers, estate and succession planning.