FROEHLING ANDERSON

What TCJA Really Means For Your Business

The Tax Cuts and Jobs Act:
Qualified Business Income Deduction

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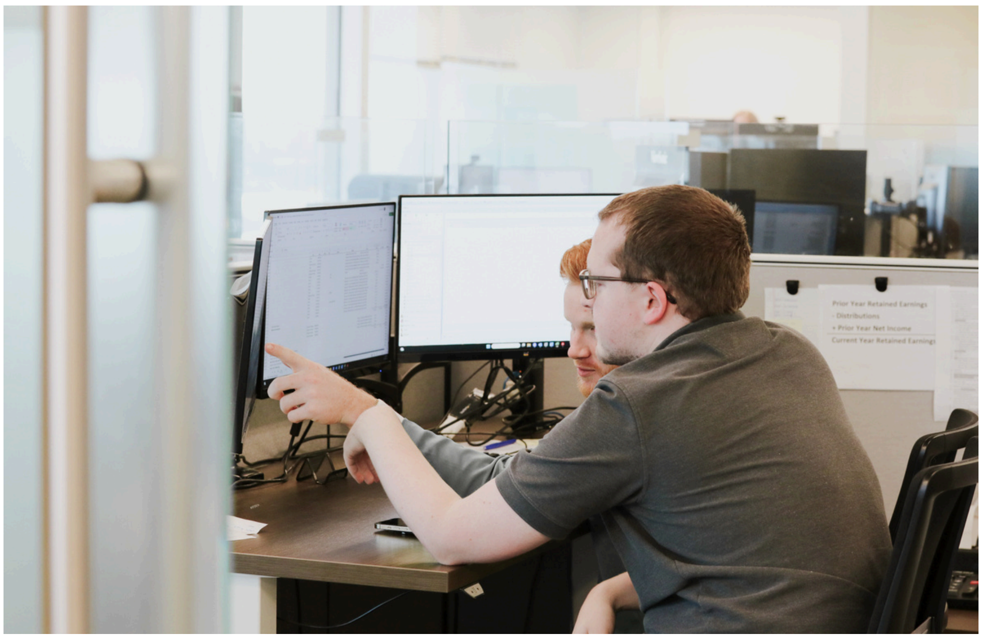
Overview of the QBI Deduction

The 2017 Tax Cuts and Jobs Act, as amended by the Tax Technical Corrections Act of 2018, provides a new tax benefit to individuals to create some parity with the reduced corporate tax rates. For tax years beginning after 2017 and before 2026, individuals, estates, and trusts may be able to deduct up to 20% of the qualified business income from each of their trades or businesses (IRC Section 199A).

Generally, the deductible amount is 20% of the individual's share of the business's qualified business income (QBI). However, limitations apply when the individual's taxable income exceeds certain threshold amounts. In this instance, the deduction is limited to an amount based on the business's W-2 wages or a combination of its W-2 wages and its investment in qualified property (the wage/investment limit).



The QBI deduction is not allowed for individuals in certain specified service businesses unless their income is less than certain threshold amounts. As a result, it's important to understand the federal tax considerations associated with a specified service business and potential opportunities to limit the negative impact it has on the QBI deduction.

<u>What is a Specified Service Business?</u>

A specified service business is a trade or business to which any of the following applies [IRC Sec. 199A(d)(2)]

The types of specified service businesses listed below are defined by reference to IRC Sec. 1202(e) (3)(A), but engineering and architecture are specifically excluded. The IRS will likely issue additional guidance later on what constitutes a specified service business.

A. It involves the performance of services in the fields of health, law, accounting, actuarial sciences, performing arts, consulting, athletics, financial services, or brokerage services.

B. Its principal asset is the reputation or skill of one of its owners or employees.*

C. It involves investing and investment management, trading, or dealing in securities, partnership interests, or commodities.

Determining whether a taxpayer is engaged in a specified service business isa critical step, since income from such a business is not QBI for taxpayers with taxable income over the threshold amount.

*In some cases, whether an owner's or employee's skill or reputation is the principal asset of a business may be difficult to determine. Presumably, this was included in the definition of a specified service business to prevent employees from forming an entity (such as a single member LLC) and having their former employer pay a consulting fee to that entity in an attempt to convert wages into QBI. The IRS plans to issue regulations which will hopefully answer this question. This has very limited applications based on proposed regulations.

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Understanding Threshold Amounts

Income from a specified service business can be treated as QBI only if the taxpayer's taxable income (before the QBI deduction) does not exceed an annually adjusted threshold (for 2018, $315,000 for MFJ and$157,500 for all others). The amount of specified service business income that can be treated as QBI phases out when taxable income (before the QBI deduction) exceeds the threshold amount and is fully phased out when taxable income exceeds the threshold by $100,000for MFJ ($50,000 for all other filers). So, for 2018, taxpayers with taxable income of $415,000or more (MFJ, $207,500 all other filers) cannot treat any income from a specified service business as QBI.

Taxpayers with taxable income in the phase-out range can only consider their applicable percentage of the specified service business's net income (or loss), W-2 wages, and qualified property when they compute their deductible amount for that business. The applicable percentage is 100% reduced by the percentage obtained by dividing the amount by which their taxable income exceeds the threshold amount by $100,000 (for joint filers; $50,000 for all others) [IRC Sec. 199A(d)(3)].

Understanding Threshold Amounts Continued...

	Taxable Income		
Single	<$157,500	>$157,500 but < $207,500	>$207,500
Married Filing Jointly	<$315,000	>$315,000 but < $415,000	>$415,000
Non-Service Business	QBI deduction allowed with no limits	Taxpayer loses some or all of deduction depending on W-2 wages & qualified property (sliding scale)	Deduction is limited to 50% of W-2 wages OR 25% of W-2 wages plus 2.5% qualified property
Service Business	QBI deduction allowed with no limits	Deduction is reduced depending on % income exceeds threshold amounts	All deduction is phased out

Understanding Threshold Amounts Continued...

Example:

Carolyn files a joint return and practices law through Woodson, LLC, a disregarded single member LLC.

Her taxable income for 2018 (before any QBI deduction) is $375,000, which includes $200,000 from her law practice. Because her taxable income is over $315,000 but not over $415,000, the specified service business exception is subject to a phase out. Carolyn's taxable income over the threshold ($375,000 − $315,000 = $60,000) is 60% into the phase-out range. Therefore, her applicable percentage is 40% and only $80,000 ($200,000 × 40%) of her income from Woodson, LLC is QBI.

($375,000 − $315,000 = $60,000)
is 60% into the phase-out range

Woodson, LLC pays an administrative employee $50,000 during 2018. It had no qualified property. For 2018, Carolyn can only take $20,000 ($50,000 × 40%) of Woodson's W-2 wages into account to compute her deductible amount with respect to Woodson.

When to Consider Reducing Taxable Income

Taxpayers with taxable income near or slightly over the threshold amounts should consider traditional planning techniques to decrease their taxable income.

These can include:

- Bunching income into one year and deductions into the next so that the QBI can be claimed every other year.
- Claiming bonus depreciation on any applicable assets.
- Using cost segregation studies to increase the allocation to assets available for bonus or accelerated depreciation.
- Making deductible retirement plan contributions.
- Making deductible HSA contributions.
- Contributing to donor-advised funds or bunching charitable contributions into one year.
- Monitoring capital gains and selling sufficient loss assets by year-end to offset them.
- Gifting income-producing assets to children (but beware of kiddie tax rules).

If taxable income is sufficiently reduced, some or all of any income from a specified service business could qualify as QBI. Also, the wage/investment limit can be avoided or mitigated by managing taxable income since that limit is phased in at the same income thresholds.

How Froehling Anderson Can Help

Froehling Anderson provides business consulting, tax, audit, and accounting services with the same personal delivery of high standards and quality that have sustained us for 77 years. Your team at Froehling Anderson includes former controllers, business owners, and CFOs.

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We specialize in uncovering aspects of your business that may be impacting profitability and growth negatively. We provide practical and technically sound solutions tailored to your unique challenges.

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Our audit and assurance team is dedicated to understanding your business risks, enhancing internal controls, addressing accounting concerns, and ensuring the quality of information crucial for your business decisions.

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Partner with us for finance and accounting solutions that go beyond the surface. Our team is committed to identifying business risks, enhancing internal controls, evaluating accounting issues, and ensuring the quality of information pivotal to your business decisions.

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