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## Tax Reform: Wow, New 20 Percent Deduction for Business Income

Rejoice if you operate your business as a sole proprietorship, partnership, or S corporation, because your 2018 income from these businesses can qualify for some or all of the new 20 percent deduction.<sup>1</sup>

You also can qualify for the new 20 percent 2018 tax deduction on the income you receive from your real estate investments, publicly traded partnerships, real estate investment trusts (REITs), and qualified cooperatives.<sup>2</sup>

In this article, you will see the big picture of how this new 20 percent deduction works.

### ***Basic Look***

When can you as a business owner qualify for this new 20 percent tax deduction with almost no complications?

To qualify for the 20 percent with almost no complications, you need two things: First, you need qualified business income from one of the sources above to which you can apply the 20 percent. Second, to avoid complications, you need “defined taxable income” (see footnote 3) of<sup>3</sup>

- \$315,000 or less if married filing a joint return, or
- \$157,500 or less if filing as a single taxpayer.

**Example.** You are single and operate your business as a proprietorship. It produces \$150,000 of qualified business income. Your other income and deductions result in defined taxable income of \$153,000. You qualify for a deduction of \$30,000 (\$150,000 x 20 percent).

If you operate your business as a partnership or S corporation and you have the qualified business income and defined taxable income numbers above, you qualify for the same \$30,000 deduction. The same is true if your income comes from a rental property, real estate investment trust, or limited partnership.

Some unfriendly rules apply to what Section 199A calls a specified service trade or business, such as operating as a law or accounting firm. But if the doctor, lawyer, actor, or accountant has defined taxable income less than the thresholds above, he or she qualifies for the full 20 percent deduction on his or her qualified business income.

In other words, if you were a lawyer with the same facts as in the example above, you would qualify for the \$30,000 deduction.

For more on how the service trade or business rules work, see *Tax Reform Sticks It to Doctors, Lawyers, Athletes, Traders, and Others*.

## ***Qualified Business Income***

The term “qualified business income” means the net of qualified items of income, gain, deduction, and loss with respect to any of your qualified trades or businesses.<sup>4</sup>

Although qualified business income does not include any qualified REIT dividends, qualified cooperative dividends, or qualified publicly traded partnership income, such dividends and income qualify for the 20 percent deduction under separate special rules.<sup>5</sup>

If the qualified business income produces a loss, then the loss creates a zero benefit for the year, and that loss carries over to the next year to ensure that your loss of money is penalized.<sup>6</sup>

Your qualified business income is from conduct of trades or businesses within the United States only.<sup>7</sup>

You do not include in qualified business income

- any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss;<sup>8</sup>
- any dividend, income equivalent to a dividend, or payment in lieu of dividends;<sup>9</sup>
- any interest income other than interest income that is properly allocable to a trade or business;<sup>10</sup>
- reasonable compensation paid to you by any qualified trade or business of yours (such as an S corporation) for services rendered with respect to that trade or business;<sup>11</sup> or
- any guaranteed payment described in IRC Section 707(c) paid to you as a partner for services rendered with respect to the trade or business or, to the extent provided in regulations, any payment described in Section 707(a) to you as a partner for services rendered with respect to the trade or business.<sup>12</sup>

**Example.** You own five rental properties, all of which produce defined taxable income, and they are your sole source of qualified business income. During 2018, the five properties produce \$70,000 of income on your Schedule E. You also sold one property at a \$50,000 long-term capital gain, which you properly reported on forms other than Schedule E. Because of your itemized deductions, your defined taxable income for the year is \$105,000.

Your 20 percent deduction is \$14,000 ( $\$70,000 \times 20$  percent). You consider the operating income of the rentals, and you don't include the capital gain as qualified business income.

## ***Defined Taxable Income Limit***

In the two previous examples, you did not suffer from the defined taxable income limit or face any of the complications in calculating your deduction.

Once you hit the income limit, you can trigger complications to your benefit, depending on the type of business you operate and whether you have wages and/or depreciable property. But for now, let's stay with the two basic limits and see how the defined taxable income limit comes into play.

**Example.** You are the sole operator of a proprietorship that is not a service trade or business. It creates \$400,000 of qualified business income. Because of other deductions, you and your spouse have \$300,000 of defined taxable income. Your 20 percent tax deduction is \$60,000 ( $\$300,000 \times 20$  percent) because you must apply the 20 percent to the lesser of your defined taxable or qualified business income.

## ***Beating the Income Limit with Wages***

Once you exceed the income limits as a non-specified service trade or business (including the phaseout limits discussed later), you face a "lesser than" calculation, one of which goes like this: Your deductible amount is the lesser of<sup>13</sup>

- 20 percent of your qualified business income, or
- 50 percent of the W-2 wages with respect to the qualified business.

W-2 wages are the total wages subject to wage withholding, elective deferrals, and deferred compensation paid by the qualified trade or business with respect to employment of its employees during the calendar year.<sup>14</sup>

W-2 wages do not include any amount that is not properly allocable to the qualified business income as a qualified item of deduction.<sup>15</sup>

In addition, W-2 wages do not include any amount that was not properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for such return.<sup>16</sup>

**Example.** You and your spouse have \$1.2 million of defined taxable income for the year. Of this, you have qualified business income of \$200,000, and that business paid \$120,000 of qualified wages. Your deductible amount is the lesser of

- \$40,000 ( $\$200,000 \times 20$  percent) or
- \$60,000 ( $\$120,000 \times 50$  percent).

Your 20 percent Section 199A qualified business income deduction is \$40,000 (the lower amount).

**Planning note.** Because you and your spouse were over the defined taxable income limit of \$315,000 plus the \$100,000 phaseout (\$415,000), you needed the wages to qualify for the deduction. In this example, with no wages, your Section 199A deduction would have been zero.

## ***Beating the Income Limit with Property***

If your defined taxable income is greater than

- the thresholds (\$157,500 single or \$315,000 married) plus
- phaseouts (\$50,000 single or \$100,000 married),

you get a zero qualified business income deduction unless you have wages or property. Above, we used the 50 percent of wages calculation, which is the first of two possible wage exceptions and which would solely apply in the absence of property. Here, we are going to use the second favorable exception, which consists of wages and/or property.

Under this rule and ignoring the “50 percent wage only” rule, your Section 199A deduction is the lesser of<sup>17</sup>

- 20 percent of defined taxable income,
- 20 percent of your qualified business income, or
- the sum of 25 percent of the W-2 wages with respect to the qualified trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property.

The term “qualified property” means depreciable tangible property<sup>18</sup>

- that is held by, and available for use in, the qualified trade or business at the close of the taxable year;
- that is used at any point during the taxable year in the production of qualified business income; and
- for which the depreciable period has not ended before the close of the taxable year.

For Section 199A, the term “depreciable period” means, with respect to qualified property of a taxpayer, the period beginning on the date the property was first placed in service by the taxpayer and ending on the later of<sup>19</sup>

- the date that is 10 years after such date, or
- the last day of the last full year in the applicable recovery period, ignoring any alternative depreciation system period under Section 168(g).

**Example.** You are single with defined taxable income of \$500,000. You have qualified business income of \$420,000. Your qualified business owns a building and machinery that qualify as qualified property and that have an original cost (no improvements) of \$1.2 million. The business pays no wages. Most of the work is done by robots. Your Section 199A deduction is the lesser of

- \$84,000 ( $\$420,000 \times 20$  percent), or
- \$30,000 ( $\$1.2$  million  $\times 2.5$  percent).

## ***Takeaways***

You now have the big picture of how the new 20 percent tax deduction works to reduce your defined taxable income on your Form 1040.

One key point is that your deduction is not limited or complicated when your income is less than \$157,500 if you are single, or less than \$315,000 if you file jointly with your spouse. Even the out-of-favor specified service trade or business qualifies for the full 20 percent of qualified business income deduction when defined taxable income is less than the limits.

Once you are above the income limits, you suffer the \$50,000 phaseout if you are single or the \$100,000 phaseout if you are married filing jointly. For how the phaseouts work for both the out-of-favor specified service trade or business and the in-favor group, see [Tax Reform: Will Section 199A Phase In or Phase Out Your 20 Percent Deduction?](#)

Once you are above the thresholds and phaseouts, you can qualify for the Section 199A deduction only when

- you are not in the out-of-favor group (accountant, doctor, lawyer, etc.), and
- your qualified business pays W-2 wages and/or has property.

[Client Letter on This Article for Use by Tax Pros. Click Here.](#)

1 IRC Section 199A.

2 Ibid.

3 IRC Section 199A(a) defines taxable income as the taxpayer's taxable income over any net capital gain and qualified cooperative dividends, plus (b) the lesser of 20 percent of qualified cooperative dividends and taxable income (reduced by net capital gain). This sum may not exceed the taxpayer's taxable income for the taxable year (reduced by net capital gain).

4 IRC Section 199A(c)(1).

5 Ibid; IRC Sections 199A(b)(1)(B); 199A(e).

6 IRC Section 199A(c)(2).

7 IRC Section 199A(c)(3)(A).

8 IRC Section 199A(c)(3)(B)(i).

9 IRC Section 199A(c)(3)(B)(ii).

10 IRC Section 199A(c)(3)(B)(iii).

11 IRC Section 199A(c)(4)(A).

12 IRC Sections 199A(c)(4)(B); 707(c); 199A(c)(4)(C); 707(a).

13 IRC Section 199A(b)(2).

14 H.Rpt. 115-466, p. 217.

15 IRC Section 199A(b)(4)(B).

16 IRC Section 199A(b)(4)(C).

17 IRC Section 199A(b)(2).

18 IRC Section 199A(b)(6)(A).

19 IRC Sections 199A(b)(6)(B); 168(g).