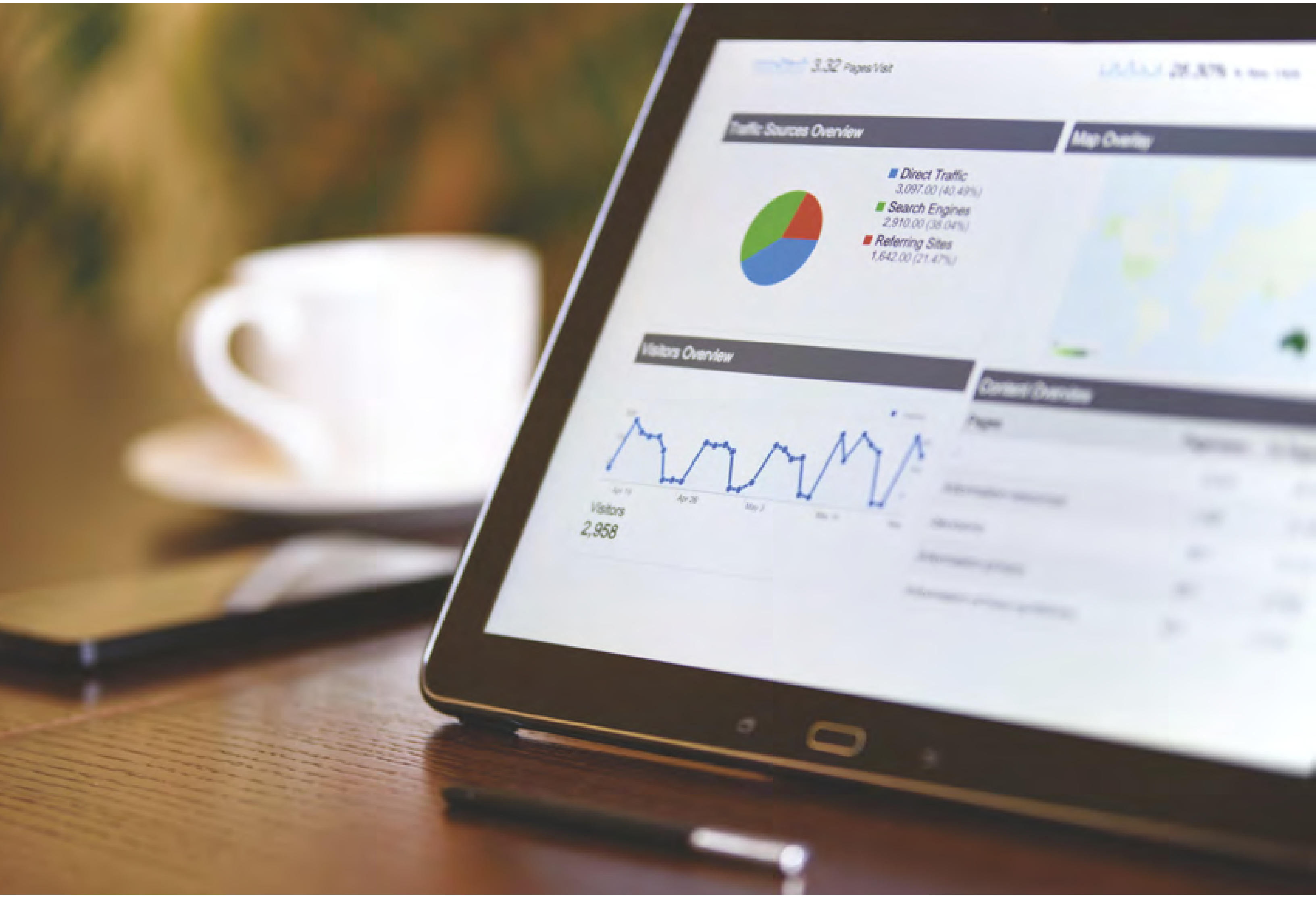

THE NEW QBI DEDUCTION PROVIDES INCENTIVE TO GROW BUSINESSES

STARTING IN 2018, individuals can claim the new qualified business income (QBI) deduction for as much as 20% of their business income passing through from partnerships, limited liability companies (LLCs), S corporations and sole proprietorships. The deduction results in a lower effective rate for business income. For those in the top bracket of 37%, business income is effectively taxed at as low as 29.6% (37% x 80%), a savings of 7.4%. Similarly, income that would have been taxed at 22%, the marginal rate for couples with taxable income between $77,400 and $165,000, is effectively taxed at as low as 17.6% (22% x 80%), a savings of 4.4%. Without Congressional action, the QBI deduction will expire after 2025.

Income from any profit-seeking venture with the potential to create jobs or cause capital investments in the United States is eligible for the QBI deduction. While no industry is excluded, income from a specified service business (SSB) may yield a reduced deduction or no deduction at all. In addition, nonqualified ordinary dividends from real estate investment trusts (REITs), patronage dividends from cooperatives and ordinary gains from sales of interests in publicly traded partnerships (PTPs) are eligible for the QBI deduction. Compensation earned as an employee or as a guaranteed payment from a partnership is not eligible for the deduction.

For the few who receive patronage dividends, the QBI deduction computation requires calculating multiple intermediate amounts and applying several different limitations, since patronage dividends are taken into account separately. Joint filers with no patronage dividends who have taxable income before the QBI deduction of $315,000 or less ($157,500 for all other filers) compute their QBI deduction in a few easy steps. First, they determine the net taxable income from all their businesses. This includes all business income, gain, deductions and losses reportable on the return. If a net loss is not currently deductible, it does not factor into the calculation.

If the cumulative net taxable income from all businesses is positive, 20% of the sum of the net business taxable income, nonqualified REIT dividends and PTP income is compared with 20% of ordinary taxable income (excluding net capital gain) before the QBI deduction. The taxpayer can claim the lesser of these two as a QBI deduction.

For taxpayers above the $157,500/$315,000 taxable income threshold (indexed for inflation after 2018), the computation is a bit more complicated. At this level, the QBI deduction is limited based on job creation and capital investment, and the calculation is more restrictive for SSBs.

SSBs are businesses engaged in accounting, actuarial, athletics, brokerage, consulting, finance, health, law, performing arts, investing and investment management, trading, or dealing in securities, partnership interests or commodities. An SSB also includes any business whose principal asset is the reputation or skill of one or more of its employees or owners, except for architecture and engineering businesses.

For businesses other than SSBs, the job creation and capital investment limitation (JCCIL) is the greater of 50% of W-2 wages or the sum of 25% of W-2 wages and 2.5% of the unadjusted basis of qualified property. Partners in partnerships and shareholders of S corporations use their proportionate shares of wages and qualified property in the computation.

Qualified property is depreciable tangible property used for the production of income that has either not yet been in service for 10 years or has not yet reached the end of its recovery period for calculating depreciation.

If 20% of the net income from a business exceeds its JCCIL, all or a portion of the excess may be disallowed in computing the QBI deduction. The disallowance percentage is based on the amount of taxable income before the QBI deduction in excess of the $157,500/$315,000 threshold. The disallowance percentage reaches 100%, if taxable income before the QBI deduction is $415,000 or more for joint filers or $207,500 or more for all other filers. Therefore, taxpayers with taxable income at these levels cannot have a QBI deduction from a business greater than that business's JCCIL, since the entire excess is disallowed.

Nonqualified REIT dividends, income from PTPs and patronage dividends are not subject to a JCCIL.

To calculate the QBI deduction for an SSB, the amounts of income, W-2 wages and business property taken into account are themselves reduced for taxpayers above the $157,500/$315,000 threshold. The reduction is based on the excess of taxable income before the QBI deduction over the threshold amount. If taxable income is $415,000 or more for joint filers (or $207,500 or more for all others), the W-2 wages and qualified property are reduced to zero, resulting in zero JCCIL. Therefore, taxpayers at these levels of taxable income cannot claim a QBI deduction for an SSB, since the deduction is limited to JCCIL, which is zero. If the reduced JCCIL is greater than zero, the rest of the computation of the QBI deduction for the SSB is the same as for other businesses.

In calculating the alternative minimum tax (AMT) QBI deduction, the only difference is the use of AMT taxable income before the QBI deduction instead of regular taxable income. Business income is not modified for any AMT preferences or adjustments.

The QBI deduction is only available for determining regular income tax and AMT. It does not reduce net earnings from self-employment or the amount subject to net investment income tax.

The IRS is expected to issue much needed guidance on the QBI deduction in July. Until then, it is uncertain how the IRS will interpret the new law. In addition, Congress may enact some technical corrections later this year.

Those with significant investments in closely held businesses should reevaluate their choice of entity in light of the new QBI deduction as well as the new flat corporate tax rate of 21%. The right choice will not be the same for everyone, and business owners should seek assistance from a competent tax adviser. ■

Peter Desmond Hopkins, CPA, MS, Cover & Rossiter, P.A. Peter is a Manager in the Tax Department of Cover & Rossiter, where he focuses on trusts and estates.