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URGENT REPORT

The Tax Cuts & Jobs Act: Qualified Business Income Deduction

Special Provisions Related to Specified Service Businesses

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General Summary of the Qualified Business Income 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.

What is a specified service business?

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

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.

The types of specified service businesses listed above 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 this summer on what constitutes a specified service business.

Determining whether a taxpayer is engaged in a specified service business is a 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. But, in some situations, the facts are less clear. In *Owen*, the court found that the principal assets of a company selling insurance and financial products were its training and organizational structure, even though the company's success was attributable to certain of its employees effectively using those assets. The IRS plans to issue regulations this summer which will hopefully answer this question.

Threshold amounts for specified service businesses

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 $100,000 for MFJ ($50,000 for all other filers). So, for 2018, taxpayers with taxable income of $415,000 or 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)].

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.

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.

Reducing taxable income to stay under the threshold amount

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.

Segregating the business

While some businesses are clearly a specified service business (e.g., the practice of law, medicine, or accounting), there may be situations where the taxpayer is engaged in more than one trade or business. For example, an optometrist who also sells glasses and contact lenses may be able to segregate the income and expenses from those businesses. Income from the practice of optometry would be from a specified service business, but income from the retail operation would not, and therefore would not be subject to exclusion from the definition of QBI.

Example

Dr. Jack is single and a self-employed optometrist. In addition to eye exams, his office also sells glasses and contact lenses. Therefore, he appears to be conducting both a specified service (optometry) and nonservice business (retail sales). For 2018, he expects his taxable income to be $300,000. If all of his income is from a specified service business, he will have no QBI (and therefore no 20% QBI deduction). If he segregates the two businesses, the breakdown of income attributable to his practice as well as his QBI deduction calculation are as follows:

Description	Retail Business (sale of glasses, etc.)	Service Business (eye exams, etc.)
Qualified business income (QBI)	$150,000	$100,000
W-2 wages paid by business	100,000	50,000
Qualified property	75,000	25,000
Overall taxable income before QBI deduction	300,000	300,000
Applicable threshold for single taxpayer	157,500	157,500
Applicable phase-out range	50,000	50,000
Specified service business phase-in %	N/A	0%
Calculation of deduction:		**N/A**
Potential deductible amount ($150,000 x 20%)	30,000	
W-2 Wage limit ($100,000 x 50%)	50,000	
Wage/investment limit ($100,000 x 25% + $75,000 x 2.5%)	26,875	
Wage/investment limitation [greater of W-2 wage limit ($50,000) or wage/investment limit ($26,875)][a]	50,000	
Deductible amount for this business [lesser of $30,000 or wage/investment limitation ($50,000)]	30,000	

[a]Due to the taxpayer's income, the wage/investment limitation is fully phased in. Between $157,500 and $207,500, this limitation would be phased in based on 100% less (taxable income - $157,500) /$157,500.

Because Dr. Jack's taxable income exceeds the upper taxable income threshold of $207,500 ($157,500 + $50,000) (for 2018), no QBI deduction is allowed with respect to his specified service business (eye exams, etc.) However, income from the retail business (assuming the IRS recognizes it as a separate business) can qualify for the deduction. In this case, it is advantageous to maximize, to the extent possible, the income from the retail business. Assume that Dr. Jack employs a business manager and a receptionist. It may be possible to reasonably allocate a larger percentage of those individuals' wages to the optometry business. However, because Dr. Jack will be subject to the wage/investment limit on any QBI deduction from that business, the effect of such an allocation on the retail business's wage/investment limit must also be considered. Dr. Jack should look for other shared expenses that might be reasonably allocated to the optometry business.

Example

Dr. Jack examines the business activities more closely and determines that he can reasonably allocate more of the income to the retail activity, based upon time and effort spent. His business amounts do not change, just the allocation between the retail and service businesses, as follows:

Description	Retail Business (sale of glasses, etc.)	Service Business (eye exams, etc.)
Qualified business income (QBI)	$200,000	$50,000
W-2 wages paid by business	125,000	25,000
Qualified property	75,000	25,000
Overall taxable income before QBI deduction	300,000	300,000
Applicable threshold for single taxpayer	157,500	157,500
Applicable phase-out range	50,000	50,000
Specified service business phase-in %	N/A	0%
Calculation of deduction:		**N/A**
Potential deductible amount ($200,000 x 20%)	40,000	
W-2 Wage limit ($125,000 x 50%)	62,500	
Wage/investment limit ($125,000 x 25% + $75,000 x 2.5%)	33,125	
Wage/investment limitation [greater of W-2 wage limit ($62,500) or wage/investment limit ($33,125)][b]	62,500	
Deductible amount for this business [lesser of $40,000 or wage/investment limitation ($62,500)]	40,000	

[b]Due to the taxpayer's income, the wage/investment limitation is fully phased in. Between $157,500 and $207,500, this limitation would be phased in based on 100% less (taxable income - $157,500) /$157,500.

By simply taking a closer look at how income and expenses were being allocated between his service and non-service activities, Dr. Jack was able to increase his QBI deduction by $10,000.

Caution: There is currently no guidance on how to group activities to determine which make up a trade or business for the QBI deduction. However, based on Reg. 1.446-1(d), which provides that separate and distinct trades or businesses can use different accounting methods (provided they maintain complete and separable sets of books and records), the authors believe that such separate and distinct businesses can be treated as separate businesses for the QBI deduction. Establishing separate LLCs for each separate and distinct business may be helpful in this regard. Practitioners should be alert for guidance in this area.

Incorporating the business

If the taxpayer's taxable income will regularly cause the taxpayer to exceed the threshold to treat specified service business income as QBI, the taxpayer may wish to convert the business to a C corporation and take advantage of the lower corporate tax rate of 21%. This will also save Medicare tax on any amounts not paid as salary to the taxpayer, although the IRS may challenge the amount paid out as compensation if it is not reasonable for the services performed. It may be difficult to justify that compensation in a personal services business is not equal to the net income of the business. In addition, the taxpayer should be aware that there will be also be taxation, most likely at a 15% or 20% rate, upon retrieving cash from the business either as a dividend or by selling stock in the company.

Example

Alice Burton, DDS, a single taxpayer with no dependents, runs a dental practice as a sole proprietorship. She employs two other dentists, four dental hygienists, and a receptionist as part of the business, as well as treats her own patients. Her net income from the business is $500,000. She has no other source of income. She wants to know if it would be more tax advantageous to incorporate the business as a C corporation.

If Alice does not incorporate, her taxable income, after reducing her Schedule C income of $500,000 by the one-half self-employment tax deduction of $14,656 and the standard deduction of $12,000 is $473,344. She has an income tax liability of $141,360, a self-employment tax liability of $29,312, and the additional 0.9% Medicare tax of $2,356 for a total tax of $173,028.

If Alice does incorporate, she will need to determine a reasonable salary for managing her business and treating her patients. Assume that her reasonable compensation would be $275,000. The corporation would have taxable income of $213,052 [$500,000 - $275,000 salary - $11,948 (the company's share of social security taxes)]. The corporation would pay $44,741 in taxes at a flat 21% tax rate. The corporation would then distribute the remaining cash of $168,311 in dividends to Alice. Alice's net taxable income would be $431,311 ($275,000 wages + $168,311 dividends - $12,000 standard deduction). Of this, $263,000 would be taxed at ordinary rates and $168,311 would be taxed at the qualified dividend rates of 15% and 20%, resulting in a tax liability of $93,262. She would also owe $11,948 for her share of social security taxes, $6,396 for the 3.8% net investment income tax, and $675 for the additional 0.9% Medicare tax, for a total tax liability of $112,281. The combined tax liability for her and the corporation would be $168,970 ($44,741 + $11,948 + $112,281).

Alice would save $4,058 ($173,028 - $168,970) in federal income and employment taxes by incorporating her business. She would need to compare this reduction in tax costs to the increased administrative costs of operating as a corporation. She would also need to consider the state and local tax effects of operating as a C corporation.

Caution: Before incorporating, the taxpayer should consider the possibility of personal holding company status under IRC Sec. 543(a)(7), subjecting them to a 20% excise tax on undistributed income. The taxpayer should also consider the ramifications if the corporation will be considered a personal service corporation as defined in IRC Sec. 448(d)(2), Reg. 1.441-3(c), and/or Temp. Reg. 1.448-1T(e).

Conclusion

The 2017 Tax Cuts and Jobs Act has created a new level of tax planning issues and strategies for specified service businesses. However, there is still uncertainty regarding how the IRS will regulate the QBI deduction, classification as a specified service business, and segregation of businesses. As of the date of this report, the IRS is expected to release proposed regulations in July or August. Until then, practitioners should continue to be alert for future guidance in this area.

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Checkpoint Learning Webinar:
The New Qualified Business Income Deduction (QBID)

For all businesses it will be necessary to reconsider choice of entity in light of the new tax law — and there are several limitations and requirements to take advantage of this new opportunity. This two-hour webinar offers examples to help you understand the QBID and examines many tax planning opportunities to enable you to provide the greatest assistance to your clients.

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