

Key takeaways from the new 20% Qualified Business Income (QBI) deduction

As a component of major tax reform at the end of 2017, the Tax Cuts and Job Act created a new tax benefit for owners of businesses taxed as pass through entities (sole proprietor, partnership, s-corporation or a limited liability company taxed as one of these) as well as investors in real estate.

This tax benefit first applicable for the 2018 calendar year, known as the 20% Qualified Business Income (QBI) deduction, is found in tax code Section 199A and is rather complicated. Congress used only nine pages to explain QBI in the new tax law¹. During August 2018, the IRS released 248 pages² of regulations to interpret what Congress outlined in nine pages.

In its purest form, the calculation of the QBI deduction is rather simple. A taxpayer is entitled to a deduction equal to 20% of their qualified business income. For example, if a taxpayer has \$100K of QBI income, the taxpayer receives a deduction of \$20K against income. However, several limitations complicate the entire calculation.

This whitepaper discusses the deduction at a high level, omits some parts for brevity sake, and arms readers with several key takeaways to discuss in greater detail with their tax advisor.

Takeaway #1 - If your total **taxable income** on form 1040 (including wages, pass through income, interest & dividends, etc. minus deductions) is below **\$321,400 for joint filers or \$160,700 for single filers** (2019 figure), the calculation of the QBI deduction may be as simple as what is described above and your deduction may not be limited. Seek income deferral opportunities if you are on the bubble to fully qualify.

However, if your total taxable income is above this threshold then read on.

Takeaway #2 - If your pass through business income is NOT from a service entity (for example, you sell products), then the deduction is generally still available to you even if you are above the aforementioned income figures. You may be subject to additional limitations in the following takeaways.

If your total income is above the threshold in #1 AND your trade is one of the specified service businesses in #3 then you receive a partial deduction until your income is above \$421,400 for joint filers and \$210,700 for single filers. **Once income is above this level AND from a specified service business, you receive no deduction.**

Takeaway #3 - The final regulations define a specified service business as a trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners.

Per the final regulations, **brokerages services do not include “services provided by real estate agents and brokers, or insurance agents and brokers.”**

¹ <https://www.congress.gov/115/plaws/publ97/PLAW-115publ97.pdf>

² <https://www.irs.gov/pub/irs-drop/td-reg-107892-18.pdf>

Takeaway #4 - The final regulations seem to imply that service businesses based on the reputation or skill of one or more of its employees or owners refers to endorsements or the licensing of an individual's likeness or features, or appearance fees. **Thus, there appears to be reprieve from a "catch all" deduction denial of all service businesses above the income thresholds.**

Takeaway #5 - Simply paying yourself a wage from your business may allow you to receive the deduction. A crucial piece of the QBI deduction is the limitation of the deduction to the LESSER of 20% of the taxpayer's qualified business income OR the greater of 50% of the W-2 wages with respect to the business or 25% of the wages plus 2.5% of the unadjusted basis of all qualified property once income is over the threshold.

Thus, if you are over the income threshold where this limitation applies in full AND not a specified service business, **no wages or qualified property = no deduction.**

Taxpayers should ask their tax advisor if they should pay themselves a W-2 salary or increase their wages for more of a deduction. Weigh the cost of additional payroll taxes against this new deduction. Also, more wages may provide opportunities to maximize qualified retirement plans. See Frontier's whitepaper, *Retirement Plans for Business Owners*, for more information.

Takeaway #6 – Owners of investment real estate either in direct property or as an investor in a REIT (Real Estate Investment Trust) or PTP (Publicly Traded partnership) may be eligible for the deduction as well.

In order to receive the QBI deduction (still subject to all of the limitations mentioned above) direct ownership of real estate must qualify as a business. Under IRS Notice 2019-07³, if a taxpayer documents 250 hours of "rental services" activities for the investment then the rental income may be eligible for the deduction.

Takeaway #7 - Qualifying dividends from REIT and PTP investments should generally be eligible for the QBI deduction without being subject to income phase-outs. Box five of form 1099-DIV reports the Section 199A dividends eligible for the QBI deduction. Your investment custodian may have released a corrected 1099-DIV reclassifying dividends to box five. **If you filed your tax return early without a corrected 1099-DIV, check to see if you missed this deduction.** Review where your investments are located in each type of account with your financial advisor. REITs and PTP shares held in IRAs will not be eligible for the deduction.

Takeaway #8 - If you think you are entitled to this new tax benefit, review line nine on page two of your form 1040 for the QBI deduction.

Scot Jackson, CPA, CFP®
Director of Financial Planning

Frontier Investment Management Company does not offer tax or legal advice. Please consult with your attorney and/or CPA for specific tax or legal matters and to implement any strategies discussed herein.

³ <https://www.irs.gov/pub/irs-drop/n-19-07.pdf>