Qualified Business Income Deduction – IRC 199A

§ 1.01 In general

The Tax Cuts and Jobs Act of 2017 added IRC 199A. This section provides individuals a tax deduction equal to 20 percent of business income. Congress enacted this deduction to give individuals a reduction in taxes associated with business income that is similar to the reduction of corporate tax rates to a flat rate of 21 percent. The deduction is taken at the individual level but the deduction is also available for business income associated with income received from partnerships and S corporations.

The deduction effectively makes the maximum income tax rate on business income 29.6 percent (calculated as the maximum income tax rate of 37 percent x 80 percent). The deduction is not available against the self-employment tax.

Generally, the deduction is calculated as the lesser of 20 percent of qualified business income or 20 percent of taxable income excluding the portion of taxable income taxed at preferential rates. For higher income taxpayers the maximum deduction is limited by 1) the type of services performed by a business and 2) wages paid and the adjusted basis of property.

Qualified business income is generally derived from a trade or business. A trade or business for purposes of the section 199A deduction can include rental real estate enterprise if the taxpayer performs at least 250 hours of services for the enterprise during the tax year.

§ 1.02 Calculation of deduction for lower income taxpayers

For single taxpayers with taxable income of less than $157,500 and married file joint taxpayers with taxable income of less than $315,000 the qualified business income deduction (QBID) is calculated as the <u>lesser</u> of 1) 20 percent of qualified business income or 2) 20 percent of taxable income (excluding the portion of taxable income taxed at preferential rates).

For a sole proprietorship, qualified business income is the income reflected on schedule C reduced by the self-employed health insurance and self-employment tax deductions allowed in arriving at adjusted gross income.

Example 1: John and Mary file a joint return and have taxable income before the qualified business income deduction of $310,000. Included in the $310,000 of taxable income is $10,000 of long-term capital gains. Mary's income from her sole proprietorship is $280,000. The qualified business income deduction is calculated as follows: lesser of 1) $310,000 - 10,000 = 300,000 x 0.2 = $60,000 or 2) $280,000 x 0.2 = $56,000. The qualified business income allowed is $56,000.

Example 2: John is single and has qualified business income of $100,000 and taxable income before the qualified business income deduction of $80,935. John's qualified business income deduction is calculated as the lesser of 1) $100,000 x 0.2 = $20,000 or 2) $80,935 x 0.2 = $16,187. The qualified business income deduction is $16,187.

§ 1.03 Calculation of deduction for higher income taxpayers

§ 1.03(a) In General

For single taxpayers with taxable income of $157,500 or more and married file joint taxpayers with taxable income of $315,000 or more the qualified business income deduction either is phased out or is limited by wages paid and the unadjusted basis of property used in the business.

For Specified Service Trades or Businesses (SSTB) the qualified business income deduction is eliminated for single taxpayer's with taxable income of $207,500 or more and for married filing joint taxpayer's with taxable income of $415,000 or more. Specified Service Trades or Businesses include health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing, and trading and dealing securities.

For taxpayer not deriving income from a SSTB the deduction of 20 percent of qualified business income is further limited by the lesser of 1) 50 percent of wages or 2) 25 percent of wages plus 2.5% of the unadjusted basis of depreciable property used in the taxpayer's trade or business.

§ 1.03(b) Non-specified services trade or business

A wage limitation also applies to the allowable qualified business income deduction if a single taxpayer's taxable income exceeds $207,500 and married filing joint taxpayer's income exceeds $415,000. The phase in of an additional limitation based on wages occurs for single taxpayers with taxable income between $157,500 and $207,500 and married filing joint taxpayers with taxable income between $315,000 and $415,000. During the phase-out range, 20 percent of qualified business income is reduced by the applicable percentage multiple by the excess amount. The applicable percentage is the amount over the threshold divided by the phase-out range. The excess amount is the amount of qualified business income (without limitations) over the greater of 1) 50 percent of wages or 2) 25 percent of wages plus 2.5% of the unadjusted basis of depreciable property.

For single taxpayer's with taxable income above $257,500 and married filing joint taxpayers with taxable income above $415,000 The qualified trade or business deduction is the lesser of 1) 20 percent of qualified business income or 2) the greater of a) 50 percent of W-2 wages or b) 2.5 percent of W-2 wages plus 2.5 percent of the unadjusted basis of depreciable property. In addition, the deduction is further limited by 20 percent of taxable income before the qualified business income deduction.

EXAMPLE 1: John and Mary file a joint tax return. Their taxable income before the qualified business income deduction is $330,000. Mary's law business had income of $300,000 and paid wages of $80,000 during the year.

STEP ONE: calculate the excess amount - 20 percent of business income over 50 percent of wages - $20,000 (calculated as $60,000 (300,000 x 20%) - 40,000 (80,000 x .5).

STEP TWO - calculate the reduction ration 15% (calculated as $315,000-300,000=15,000 / $100,000 = 15 percent).

STEP THREE: reduce the 20 percent of qualified business income deduction by the reduction ration x the excess amount or $57,000 (calculated as 60,000 - (20,000 x .15 = 3,000).

§ 1.03(c) Specified services trade or business

The allowable deduction for SSTB is phased out for single taxpayers with taxable income between $157,500 and $207,500 and married filing joint taxpayers with taxable income between $315,000 and $415,000. The deduction available is the greater of the applicable percentage of business income or W-2 wages reduced by the applicable percentage of the excess amount. The excess amount is the applicable percentage of business income in excess of the applicable percentage of wages.

Example 1: John and Mary file a joint tax return. Their taxable income before the qualified business income deduction is $330,000. Mary's law business had income of $300,000 and paid wages of $80,000 during the year.

STEP ONE: determine the applicable percentage. This is calculated as 100 percent reduced by taxable income over the threshold divided by the phase-out range. The applicable percentage is 85% calculated as $315,000-300,000=15,000 / $100,000 = 15 percent. 100 percent minus 15 percent is 85 percent.

STEP TWO: multiply the qualified business income deduction and wages by the applicable percentage. Qualified business income deduction multiplied by the applicable percentage is $51,000 (calculated as $300,000 x 0.2 x 0.85). The applicable percentage of wages is $34,000 (calculated as $80,000 x .5 x .85).

STEP THREE: determine the excess amount. This is calculated as the amount of qualified business income in step two over the applicable percentage of wages or $17,000 (calculated as $51,000 - $34,000).

STEP FOUR: reduce the business income deduction by the percentage reduction of the excess amount or $2,550 (calculated as $17,000 x .15). The business income deduction allowed is $48,450 (calculated as $51,000 - 2,550 = $48,450).