

Understanding Qualified Business Income

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The 2017 Tax Cuts and Jobs Act (TCJA) lowered the top tax rate on C corporation income from 35 percent to 21 percent. This is considerably lower than the top rate of 37 percent on pass-through income from sole proprietorships, partnerships, and S corporations.

Cutting taxes for C corporations without also cutting taxes for small businesses, would probably have caused a stir with small-business owners justifiably exclaiming, “No fair!” To balance the scales, the TCJA allows small-business owners to deduct up to 20 percent of their qualified business income (QBI) from their taxable income for the year, calculated on an activity-by-activity basis.



This is a major change for most small-business owners, but it may leave you wondering what QBI is, how this change is likely to impact your taxes, and what the heck “calculated on an activity by activity basis” means? In this singlette, we bring you up to speed on the QBI deduction.

Understanding the Different Income Types

The tax code has always distinguished different types of income and taxed them differently. TCJA created an entirely new type of business income, called qualified business income (QBI), and taxes it in a unique way. In this section, we define and compare the different types of income, including QBI.

Ordinary income

Ordinary income is what you earn from your work or your business. If you draw pension or IRA income, that's ordinary income too. Here are a few key points about ordinary income:

- Ordinary income is taxed at ordinary income tax rates.
- Any salary you earn from your small business is ordinary income.
- If your small business is a sole proprietorship, your entire net profit from the business is taxed as ordinary income. (*You can change your business entity from sole proprietor to S corporation to reduce the amount taxed as ordinary income.*)
- You pay taxes on net income. So, for instance, if you file as married, you earn a salary from a job, and should your spouse lose money in a business, your spouse's business loss reduces your net income (subject to tax) as a married couple.

Investment income

Investment income is money you earn from your investment portfolio, and different types of investment income are taxed at different rates:

- Interest income is taxed at ordinary income tax rates.
- Qualified corporate dividends are taxed at special rates up to 20 percent.
- Long-term capital gains (for profits from assets held more than a year) are taxed at 0, 15, and 20 percent depending on your total income.
- Short-term capital gains on most assets (held for up to one year) are taxed at ordinary income tax rates.
- If your adjusted gross income (AGI) exceeds \$200,000 for single filers or \$250,000 for joint filers, your investment income is subject to another 3.8 percent "net investment income tax."

So, here's the deal... if you have capital losses in a fiscal year, you are allowed to subtract those losses from your capital gains (*profit from the sale of property or an investment*). And you can subtract up to \$3,000 of net capital losses against your ordinary income. But here's something you need to know: if your net capital loss is greater than \$3,000, you must carry the remainder forward to future years. So, to at least to that extent, investment income is curtailed off into a silo of its own.

By the time the Berlin Wall fell, taxpayers had figured a way around that curtain. They discovered that borrowed money could be used to increase their basis in investments like equipment leasing, oil and gas, real estate, and write off huge paper losses that were significantly in excess of what they had actually invested. They used those losses to offset their ordinary income from salaries and businesses, as well as investment income from their investment portfolios. That was great for

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taxpayers, of course, especially with marginal rates hitting 70 percent, but it wasn't so good for the U.S. Treasury, so, in 1986, Congress created a new category called *passive income* to classify income from activities in which the taxpayer doesn't "materially participate."

Passive income

The 1986 rules specified that you can write off passive losses against passive income, but not generally against ordinary income or investment income. Congress did provide for two special allowances for real estate income. The first allows for up to \$25,000 of rental property losses, but *that* phases out starting at \$100,000 of AGI. The second allows "real estate professionals" who qualify under special rules to deduct passive real estate losses against ordinary income.

However, for the most part, the 1986 rules placed passive income and losses into a third silo.

Qualified business income (QBI)

With TCJA, Congress created a fourth "silo," called *qualified business income*. QBI includes net business income from sole proprietorships, partnerships, and S corporations, but *not* C corporations.

It also includes pass-through income from real estate investment trusts, publicly traded partnerships, and qualified agricultural co-ops. But it doesn't include guaranteed payments or W2 wages you draw from your business. It also doesn't include investment income – most taxable dividends other than REITs, or co-ops, investment interest income, short-term or long-term capital gains, commodity or foreign currency gains, etc.

QBI Deduction Limits

TCJA's new QBI deduction comes with three important limitations, as described in the following sections.

Limitation #1

If your 2020 taxable income – *after* adjustments to income and itemized deductions – is more than \$163,300 (\$326,600 for joint filers) your QBI deduction for each activity is limited to the greater of the following:

- 50 percent of the W-2 wages timely paid on behalf of that activity, *or*
- 25 percent of the W-2 wages plus 2.5 percent of the initial cost – immediately after acquisition – of all tangible property placed in service on behalf of that activity. (Tangible property includes real estate, equipment and machinery, vehicles, or robots that replace your employees.) You can count the initial cost of the property toward this amount for 10 years.

Example: Suppose you own 20 percent of an S corporation that pays \$500,000 in W-2 wages and has \$200,000 of property in service. Your QBI is the greater of \$50,000 (50 percent of your 20 percent share of \$500,000 in wages) *or* \$26,000 (25 percent of your 20 percent share of \$500,000 in wages plus 2.5 percent of your 20 percent share of the \$200,000 in depreciable property).

This may mean that careful planning is required to maximize your deduction if your taxable income before subtracting QBI is enough to phase out the deduction.

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Limitation #2

If your QBI comes from a “specified service business” (medicine, law, accounting, actuarial science, financial services, consulting, performing arts, athletics, or any business that relies on the “reputation or skill of one or more employees”), your deduction for that activity phases out as your taxable income rises from \$163,300 to \$213,300 (for single filers) or from \$326,600 to \$426,600 (for joint filers).

This may mean that careful planning is required to define “specified service income activities” and segregate them from non-service activities to make the most of the opportunity. (In January 2019, the IRS issued final regulations offering more guidance in this area.)

Limitation #3

The overall QBI deduction is limited to 20 percent of your taxable income in any particular year. The 2017 Tax Cuts and Jobs Act (TCJA) makes no provision for carrying over any unused deduction. However, if your QBI for the year is below zero, you can carry the loss forward to the next taxable year.

Maximizing Your QBI Deduction

The new rules suggest several ways to maximize the new benefit. And honestly, the more time tax lawyers and accountants spend looking over these rules, the more ideas they’ll come up with. When critics of the tax bill say it will encourage “gaming the system,” *this* is the provision they’re talking about.

Let the games begin.

Create W2 income

If you currently operate a non-service business as a sole proprietor or partner, you have few or no W2 employees, and your taxable income is above the threshold, consider establishing an S corporation and paying yourself a W2 wage to create a base for taking advantage of the deduction.

“Cracking and packing”

Consider “cracking and packing” approaches to avoid the \$160,700/\$321,400 limits on specified service income.

For example, if your primary business activity is a specified personal service, consider ancillary activities – such as marketing or management – a separate activity. You’ll still lose out on the deduction for that primary service activity, but you’ll preserve the deduction for the ancillary activities that don’t fall under the service business definition. (*The IRS has issued proposed regulations stating that a specified service business includes any trade or business that provides 80 percent or more of its property or services to a specified service business, as long as the two businesses share 50 percent or more common ownership.*)

If a business earns less than 10 percent of its income from specified service activity, it won’t be considered a specified service *business* for purposes of these new rules.

Segregate real estate

If you own real estate for your business to occupy, consider separating that real estate into a separate entity and paying it the highest reasonable rent to qualify for the deduction.

Contractors to employees

If your business uses independent contractors, consider making them W2 employees to maximize the W2 base for calculating the QBI deduction. (Of course, if those contractors are *also* paying attention to the law, they may prefer to *keep* their independent contractor status!)

Final Notes on QBI

We realize this is going to sound self-serving but maximizing your QBI deduction isn't "do-it-yourself" tax planning. Just because you can buy a tool to do something yourself (instead of hiring a professional) doesn't mean you should. If you go to Amazon and search for "orthopedic bone saw," you can find them for under twenty bucks. (Take a look. Seriously, it's terrifying!) But just because you can buy the saw doesn't mean you should be performing orthopedic surgeries.

Want to read something humorous? below is something that was actually included in the *Conference Report for the Taxpayer Refund and Relief Act of 1999*:

“It is not anticipated that individuals will need to keep additional records due to the provision. It should not result in an increase in disputes with the IRS, nor will regulatory guidance be necessary to implement this decision.”

Wow! Do you think members of congress actually *believed* that at the time? Or is it just something they told themselves to feel better about unleashing new uncertainty into the system? How do you think they felt in January 2019, when the IRS issued 278 pages of regulations interpreting the new provision?

To take full advantage of the QBI deduction without running into future problems with the IRS, we urge you to obtain guidance from a qualified tax professional – if not us, then someone else.

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