Qualified Business Income Deduction

QUALIFIED BUSINESS INCOME DEDUCTION – PART I – OVERVIEW

The TCJA introduced a new deduction available to taxpayers with qualifying business income. It is first available in tax years beginning after December 31, 2017 (starting in 2018 for calendar year taxpayers). The deduction is referred to alternatively as the qualified business income (QBI) deduction, the §199A deduction, the 20% deduction, and the passthrough deduction. Here, we'll refer to it as the QBI deduction.

This is the first in a series of articles on the new deduction. We'll cover the basic calculation, who is eligible to claim the QBI deduction, and some of the applicable definitions. IRS news release IR-2018-162 announces the release of proposed regulations and Notice 2018-64 which details how W-2 wages are calculated for purposes of the wage limit (part of the QBI deduction calculation for higher-income taxpayers). The news release also links to FAQs covering many of the main QBI deduction concepts.

Eligible taxpayers. Although it is sometimes called the "passthrough" deduction, the QBI deduction is not only for passthrough entities. Taxpayers with qualified business income from sole proprietorships (Schedule C) and non-corporate farms (Schedule F) are potentially eligible for the deduction, as well as those with income form S corporations, partnerships, trusts, and estates.

Qualified business income and the basic deduction. Qualified business income is defined as the net of items of income, gain, deduction, and loss from a qualified trade or business which, generally, means one of the types of business entities listed above. The items must be effectively connected with a U.S. trade or business.

Dividends from real estate investment trusts (REITs) and income from qualified publicly traded partnerships (PTPs) may qualify as well. Capital gains and losses (from the sale of stock, for example) and interest income are not included in qualified business income. Special rules apply to agricultural and horticultural cooperatives.

The basic deduction is equal to 20% of qualified business income or, if smaller, 20% of the taxpayer's taxable income less any net capital gain and without regard to the deduction itself. It is claimed on the individual's tax return, rather than on the business return, and it is a "below the line" deduction. Thus, it will not affect the individual's AGI, the amount of business income subject to self-employment tax, etc. The QBI deduction is reported on line 9 of the current draft version of the 2018 Form 1040. We'll have more information on companion forms, worksheets, etc. when they're finalized.

Two types of businesses. For calculation purposes, businesses fall into two categories:

- Specified service trades or businesses (SSTBs) involve the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, investing and investment management, and any trade or business where the principal asset is the reputation or skill of one or more of its employees.
- All other qualifying trades or businesses.

As we'll see, for higher income taxpayers, the QBI calculation is different for income from SSTBs.

Limitations. In general, the full deduction is available to taxpayers with taxable income of $157,500 or less ($315,000 for joint filers) and limitations that apply to higher income taxpayers do not kick in until those thresholds are exceeded. As explained earlier, the deduction cannot be more than 20% of the taxpayer's taxable income over net capital gain.

> Example 1: Taxpayer A is a joint filer and part owner of an S-corporation. His K-1 (Form 1120-S) shows items which comprise qualified business income of $40,000. The taxpayer's and spouse's total taxable income is $200,000. The taxpayer's QBI deduction is not subject to the limit for higher-income taxpayers. The QBI deduction is therefore $8,000 ($40,000 QBI × 20%).
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> Example 2: Taxpayer B is a single filer whose qualified business income is $40,000 from self-employment (Schedule C). After deductions, her taxable income is $20,000. The taxpayer's QBI deduction is not subject to the limit for higher-income taxpayers, but it is restricted because her taxable income is lower than her QBI. Her QBI deduction is $4,000 ($20,000 taxable income × 20%).

Once the taxpayer's taxable income reaches the threshold, the limitation is phased in, and the QBI deduction is reduced. *How* it is reduced will depend on whether the QBI is from an SSTB.

> Example 3: Taxpayer C is a joint filer and a partner in a partnership. Her K-1 (Form 1065) shows $250,000 of qualified business income. The taxpayer's and spouse's taxable income is $325,000. Her QBI deduction will be reduced because her taxable income is over the threshold. The calculation of the reduction will vary, depending on whether the partnership is an SSTB.

We'll explore all of these concepts in depth in future QBI deduction articles, including:

- Distinguishing an SSTB from a non-SSTB.
- Calculating the reduction for the two types of businesses.
- Rental real estate issues.
- Aggregation rules.
- Other advanced calculation issues.

QUALIFIED BUSINESS INCOME DEDUCTION – PART 2: SPECIFIED SERVICE TRADE OR BUSINESS (SSTB)

In last week's TAX in the News we provided an overview of the new qualified business income (QBI) deduction, also referred to as the 20% deduction, passthrough deduction, and §199A deduction. The basic deduction is equal to 20% of qualified business income or, if smaller, 20% of the taxpayer's taxable income less any net capital gain. The QBI deduction is available to taxpayers with income from sole proprietorships, passthrough entities, and more. It is claimed on the taxpayer's individual return. See TAX in the News August 22, 2018 for the full overview. This week we'll explore one of the main concepts introduced in the overview, the specified service trade or business or SSTB.

QBI reductions and business types. The QBI deduction is reduced for higher income taxpayers. Calculating the reduction is a complex process *and* is handled differently for SSTBs and non-SSTBs. Thus, it's crucial to distinguish between the two business types before starting any calculations. Here are some important points to bear in mind:

- *QBI reductions do not affect lower income taxpayers*. Reductions kick in when the taxpayer's taxable income exceeds $157,500 ($315,000 for married taxpayers filing jointly). For those with taxable income at or under these thresholds, SSTB and non-SSTB reductions do not apply.
- *SSTB reductions are steeper than non-SSTB reductions*. Once taxable income exceeds the thresholds, the QBI deduction is more limited for an SSTB than a non-SSTB. When taxable income reaches $207,500 ($415,000 for MFJ) the QBI deduction for an SSTB is phased out altogether.
- *The SSTB determination is made at the business level*. Although the QBI deduction is claimed on the individual's tax return, the determination as to whether a business is, or isn't, an SSTB is made by the business. The regulations require passthrough entities to disclose SSTB information to shareholders, partners, etc. For example, a Schedule K-1 (Form 1065) should provide a partner with information necessary to figure the partner's allowable QBI deduction.
- *Taxable income thresholds apply at the individual level*. QBI reductions are based on the individual's taxable income, regardless of the business's income. For instance, an individual may have a small amount of qualified business income from her Schedule C business but other sources of income that put her taxable income over the threshold. If so, her QBI deduction will be limited.
- *De minimis rule*. Some businesses may provide a small amount of services in one of the specified service activities explained below. Under a de minimis rule, the business is not considered an SSTB if less than 10% of gross receipts are attributable to performance of services in a specified service activity (5% if overall gross receipts are more than $25 million).
- *Anti-Abuse rule*. Some businesses may try to avoid the SSTB reduction by creating a separate entity to hold their property or to run their back-office operations. However, a separate entity will be treated as an SSTB as well if the owners of the SSTB that created the separate entity:
    - Own at least 50% of the separate entity, and
    - The separate entity provides 80% or more of its property or services to the SSTB.

  Even if the separate entity provides less than 80% of its property or services to an SSTB, a portion of the commonly-owned entity's business may receive SSTB treatment. We'll discuss rules for taxpayers with multiple businesses in a future article.

SSTB categories. An SSTB is any trade or business involving the performance of services in one or more of the following fields:

- Health
- Law
- Accounting
- Actuarial science
- Performing arts
- Consulting
- Athletics
- Financial services
- Brokerage services
- Investing and investment management
- Trading
- Dealing in securities
- 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.

The proposed regulations (§1.199A-5(b) starting on page 158 at this link) provides guidance for each of these categories. Generally, the performance of services in any particular field means that individuals are directly engaged in providing such services to clients rather than services that are incidental or tangential to the field. For example, the performance of services in the field of law refers to services by lawyers, paralegals, legal arbitrators, mediators, and similar professionals. It does not refer to services that don't require skills unique to the field of law, such as printing, delivery, and stenograph services.

Here we explain three of the categories; see the proposed regulations for more details on these and the rest of the categories.

Accounting. The performance of services in the field of accounting means the provision of services by accountants, enrolled agents, tax return preparers, bookkeepers, and financial auditors serving in their capacity as such. The field does not include payment processing and billing analysis.

Consulting. The performance of services in the field of consulting means the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems. This field includes the services of lobbyists. It does not include the performance of services other than advice and counsel, such as sales or training and educational services.

Also, consulting does not include services that are embedded in, or ancillary to, the sale of goods or services in a business that is not otherwise an SSTB if there is no separate payment for the consulting services. The regulations provide an example of a bicycle sales and repair business in which customers typically consult with the business's experienced personnel on the best bicycles to purchase. This advice is incidental to the sales and repair services provided by the business. This bicycle business is not a consulting business and not an SSTB.

> *Example:* G owns 100% of Corp, an S corporation, which operates a bicycle sales and repair business. Corp has 8 employees, including G. Half of Corp's net income is generated from sales of new and used bicycles and related goods, such as helmets, and bicycle-related equipment. The other half of Corp's net income is generated from bicycle repair services performed by G and Corp's other employees.

> Corp's assets consist of inventory, fixtures, bicycle repair equipment, and a leasehold on its retail location. Several of the employees and G have worked in the bicycle business for many years, and have acquired substantial skill and reputation in the field. Customers often consult with the employees on the best bicycle for purchase. G is in the business of sales and repairs of bicycles and is not engaged in an SSTB within the meaning of paragraphs (b)(1)(xiii) and (b)(2)(xiv) of this section. (Ex. 7 p. 168)

A trade or business where the principal asset of such trade or business is the reputation or skill of one or more employees or owners. The preamble to the proposed regulations makes it clear that this category is *not* meant to be a catch-all that treats all service businesses that are not included in one of the other categories as SSTBs. Instead, the category is narrowly defined as follows:

- A trade or business in which a person receives fees, compensation, or other income for endorsing products or services.
- A trade or business in which a person licenses or receives fees, compensation or other income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity.
- Receiving fees, compensation, or other income for appearing at an event or radio, television, or another media format.

In another example, a well-known chef and restauranteur received $500,000 for the use of his name on a line of cooking utensils and cookware. In his capacity as a chef, neither the taxpayer nor his restaurant businesses are SSTBs. However, his trade or business consisting of the receipt of the $500,000 fee and other endorsement fees paid because of his skill and reputation is an SSTB.

> *Example:* H is a well-known chef and the sole owner of multiple restaurants each of which is owned in a disregarded entity. Due to H's skill and reputation as a chef, H receives an endorsement fee of $500,000 for the use of H's name on a line of cooking utensils and cookware. H is in the trade or business of being a chef and owning restaurants and such trade or business is not an SSTB. However, H is also in the trade or business of receiving endorsement income. H's trade or business consisting of the receipt of the endorsement fee for H's skill and/or reputation is an SSTB within the meaning of paragraphs (b)(1)(xiii) and (b)(2)(xiv) of this section. (Example 8, page 168)

The proposed regulations answer many of the questions practitioners have about SSTBs. They clarify what types of activities are encompassed in the enumerated fields, especially for businesses whose assets are primarily the "reputation and skill" of owners and employees. Coming up next: what income is included in qualified business income in order to calculate the QBI deduction.

QUALIFIED BUSINESS INCOME DEDUCTION – PART 3: QBI VOCABULARY

In the last QBI Deduction article we delved into specified service trades or businesses (SSTBs). These are businesses that perform services in various fields, such as health, accounting, and law. The QBI deduction is reduced for all taxpayers with taxable income over $157,500 ($315,000 for MFJ) but reductions are steeper for Specified Service Trades or Businesses (SSTBs) than non-SSTBs. Before going into the complicated process of calculating the reductions, we'll first cover some of the terms and definitions needed to perform these calculations. The proposed regulations provide more details on each of these items.

Qualified business income (QBI) is the taxpayer's profit from each U.S. trade or business, such as net profit from a Schedule C or Schedule F. It also includes qualified income from a relevant passthrough entity (RPE), such as an S corporation shareholder's or partner's share of the business's ordinary income. It does not include net capital gains and losses. And it does not include the taxpayer's wages, including the reasonable wage paid to an S corporation shareholder/employee, or guaranteed payments made to a partner in a partnership.

Trade or business is not specifically defined in the Internal Revenue Code. For §199A purposes, the term generally has the same meaning that it has for §162, the section that deals with expenses that are, or are not, deductible by a trade or business. As with many other aspects of taxes, ultimately, the existence of a trade or business is determined by facts and circumstances. The term does *not* include the trade or business of being an employee and, as explained above, an employee's income is ineligible for the QBI deduction. Also, former employees, i.e. individuals who were properly treated as common law employees, then who were reclassified as contractors while continuing to perform the same duties, will be treated as employees. A trade or business may be an SSTB or non-SSTB. **Note:** Rental activities will be discussed in a future article.

Beginning t**hreshold, lower threshold, or threshold amount** refers to a specific taxable income level. For 2018, the threshold is $157,500 ($315,000 for MFJ). These amounts will be adjusted for inflation after 2018. Here, taxable income refers to the taxpayer's (not the business's) taxable income, i.e. gross income less adjustments and deductions (standard of itemized), immediately before the QBI deduction. For taxpayers with taxable income at or below the beginning threshold, the QBI deduction formula is fairly straightforward. It is 20% of QBI or, if smaller, 20% of the taxpayer's taxable income, less any net capital gain. This is the only limitation that applies, whether the QBI is from an SSTB or non-SSTB.

Upper threshold or ceiling refers to the threshold amount plus $50,000 ($100,000 MFJ). Thus, for 2018 the ceiling is $207,500 ($415,000 MFJ). What happens *between* the two thresholds, and once taxable income reaches and exceeds the upper threshold *does* depend on whether the QBI is from an SSTB or non-SSTB.

Wage and property tests or limitations apply when the taxpayer's taxable income reaches the lower threshold amount. While the reduction calculations differ for non-SSTBs and SSTBs, there are two important items that must be considered for either type of calculation.

> **Wages**. This term refers to the W-2 wages that are paid to the qualifying business's common law employees on a calendar year basis, including S corporation shareholder/employees, and reported to the Social Security Administration. Note that although the taxpayer's wages are not QBI, wages do figure into deduction limitations that apply to higher income taxpayers. Notice 2018-64 provides three methods for calculating W-2 wages. The "unmodified box method," for example, uses the smaller of box 1 (wages, tips, and other compensation) or box 5 (Medicare wages and tips) for all employees. The taxpayer must use one of the three methods consistently for the tax year. See the notice for the other two methods, SSA reporting issues, fiscal year taxpayers, and other details.
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> **Unadjusted Basis Immediately after Acquisition (UBIA)**. This is the second item needed to calculate wage and property limitations. It refers to the basis of qualified property without regard to depreciation claimed, including §179, bonus depreciation, and regular MACRS deprecation. Qualified property is tangible depreciable property used in the taxpayer's U.S. trade or business operations. UBAI in most instances will simply be the cost of the qualified property. Property remains qualified for the longer of 1) 10 years, or 2) the last day of the last full year of the applicable recovery period. For example, five-year MACRS property placed in service in 2012 is still qualified property in 2018, no matter how the taxpayer depreciated it, and remains qualified through 2021.

Taken together, wages and UBIA will be used to calculate reductions that apply to the taxpayer's QBI deduction. In the next article in this series we'll go over the calculations for non-SSTBs, followed by the calculations for SSTBs. In future articles we'll discuss more advanced calculation problems, including the calculation for taxpayers with multiple businesses and/or businesses with losses, and calculations that include PTP or REIT income.

QUALIFIED BUSINESS INCOME DEDUCTION – PART 4: REDUCTIONS FOR NON-SSTBs

In previous weeks we've explained that reductions apply to the QBI deduction once a taxpayer's income exceeds a taxable income threshold.

For 2018, these thresholds are:

Lower threshold: $157,500 ($315,000 MFJ)

Upper threshold: $207,500 ($415,000 MFJ)

As a reminder, threshold amounts refer to the *taxpayer's* taxable income and not the business's income. For instance, a partnership has QBI of $500,000. Partner A, who is a single taxpayer, has a 10% interest in the business and so receives a $50,000 share of the QBI. If Partner A's taxable income exceeds $157,500, his QBI deduction will be subject to reductions. Otherwise, it will not be subject to reductions.

Reduction calculations differ for SSTB's and non-SSTBs. In this week's installment, we'll work through the QBI deduction calculations for non-SSTBs. Note, in all of the reduction calculations in our illustrations, we're starting with 20% of qualified business income. To simplify the explanation as much as possible, we'll just refer to "20% of QBI" in these examples.

Taxable income exceeds upper threshold

If a non-SSTB taxpayer's taxable income exceeds $207,500 ($415,000 MFJ), the QBI deduction is subject to a wage and property limitation. The deduction is the *smaller* of:

- 20% of QBI, or
- The wage and property limitation.

There are two methods for calculating the wage and property limitation. The *larger* result is the limitation that applies.

- Method 1: Wages × 50%
- Method 2: Wages × 25% + UBIA × 2.5%

For this purpose, wages are defined as a taxpayer's share of common law wages paid by the trade or business. UBIA stands for "unadjusted basis immediately after acquisition," which is generally the cost of property. Please refer to Part 3 of the QBI Deduction series (TAX in the News September 19, 2018) for more complete definitions of these and other terms used in the calculations.

Illustration 1: Mabel is single. She has taxable income of $275,000 and QBI of $175,000. Applicable wages are $50,000 and UBIA is $10,000. Since Mabel's taxable income exceeds $207,500, she is subject to the wage and property limitation. Her QBI deduction is figured as follows:

20% of QBI = $35,000 ($175,000 QBI × 20%)

Wage/property limitation

Method 1 = $25,000 ($50,000 × 50%) ✓

Method 2 = $12,750 [($50,000 × 25%) + ($10,000 × 2.5%)]

The deduction is the *smaller* of 20% of QBI or the above wage/property limitation, and the *larger* of that limitation's Method 1 or Method 2. Since the wage/property limitation is less than 20% of QBI, one of the two methods in that limitation must be used. And since Method 1 yields the larger result, Mabel's QBI deduction is $25,000.

Before moving on to another illustration, there are a few things to note:

- If 20% of QBI is *smaller than* the Method 1 result, there is no need to calculate Method 2. Suppose Mabel's QBI is only $80,000. Since 20% of QBI is $16,000, which is less than the Method 1 result of $25,000, Mabel's QBI deduction *is* $16,000, the smaller of the two amounts, and the Method 2 result would be irrelevant.

- The Method 2 calculation, which takes UBIA into account, will benefit taxpayers that may have little or no wages but many depreciable assets, as shown in the next example.

Illustration 2: Assume the same taxable income and QBI, but wages are $15,000 and UBIA is $200,000.

20% of QBI = $35,000 ($175,000 QBI × 20%)

Wage/property limitation

Method 1 = $7,500 ($15,000 × 50%)

Method 2 = $8,750 [($15,000 × 25%) + ($200,000 × 2.5%)] ✓

Here, Method 2 yields the better result, so Mabel's QBI deduction is $8,750.

Taxable income is between the two thresholds

If a taxpayer's taxable income is between the lower and upper thresholds, the QBI deduction is also subject to the wage/property limitation, but the calculation has extra steps. First, calculate the basic 20% of QBI amount and the applicable wage/property limitation as explained above.

Step 1. Subtract the appropriate lower threshold amount ($157,500 or $315,000) from the taxpayer's taxable income.

Step 2. Divide the Step 1 result by $50,000 ($100,000 MFJ).

Step 3. Subtract the wage/property limitation from the 20% of QBI amount.

Step 4. Multiply the Step 3 result by the Step 2 percentage. This is the **reduction amount**.

Step 5. Reduce the 20% of QBI amount by the Step 4 reduction amount.

Illustration 3: Assume the same facts as Illustration 1, but Mabel's taxable income is $190,000. As in Illustration 1, 20% of QBI ($175,000) is $35,000 and the wage/property limitation is $25,000. Since Mabel's taxable income is between $157,500 and $207,500 (the lower and upper thresholds), the additional steps are:

Step 1: $32,500 ($190,000 taxable income - $157,500 lower threshold)

Step 2: 65% ($32,500 / $50,000)

Step 3: $10,000 ($35,000 20% QBI amount - $25,000 wage/property limitation)

Step 4: $6,500 ($10,000 × 65%)

Step 5: $28,500 ($35,000 unreduced 20% QBI - $6,500 reduction amount)

It may seem odd that taxpayers with taxable income between the two thresholds have a more complicated calculation than those with taxable income above the upper threshold. One way to understand this is that the reduction amount is phased in between the two thresholds. When Mabel's taxable income was more than the upper threshold, her full QBI deduction was reduced by 100% of the reduction amount, which was $10,000 in this case. With lower taxable income, the full QBI deduction was reduced by only 65% of the reduction amount. The closer taxable income is to the lower threshold, the smaller the reduction and, conversely, the closer taxable income is to the upper threshold, the larger the reduction until it is 100% of the reduction amount, as it is in Illustration 1.

Finally, once calculations are completed, always compare the result to 20% of the taxpayer's taxable income less net capital gain. The deduction is the smaller of the two.

We'll cover the calculation for SSTBs in another installment in the QBI deduction series.

QUALIFIED BUSINESS INCOME DEDUCTION – PART 5: REDUCTIONS FOR SSTBs

In the last article in our QBI deduction series we went through the reduction calculation for businesses that are *not* specified service trades or businesses. This time we'll explain the calculation for businesses that *are* SSTBs.

Please refer to Part 3 of the QBI series (TAX in the News September 19, 2018) for definitions of the terms used in these calculations.

Taxable income does not exceed lower threshold

Reductions for SSTBs apply only when the taxpayer's taxable income exceeds the lower threshold of $157,500 ($315,000 MFJ). Otherwise, no special calculation for the QBI deduction is needed. This is so if the business is an SSTB or non-SSTB. Either way, the deduction is 20% of qualified business income or, if smaller, 20% of the taxpayer's taxable income less net capital gain. When reductions apply for higher income taxpayers, for our discussion of the reduction formula, we'll simply refer to this leg of the calculation as "20% of QBI."

Taxable income exceeds upper threshold

For SSTBs, once the taxpayer's taxable income exceeds $207,500 ($415,000 MFJ), the QBI deduction is not allowed or, stated another way, it is fully phased out.

Taxable income is between the two thresholds

If a taxpayer's taxable income is between the lower and upper thresholds, the QBI deduction is subject to a wage/property limitation, but the calculation has more steps than the non-SSTB calculation. Here are the steps:

Step 1. Find the phase-in ratio and applicable percent:

a. Subtract the lower threshold amount ($157,500 or $315,000 MFJ) from the taxpayer's taxable income.
b. **Phase-in ratio**. Divide the result in Step1a by $50,000 ($100,000 MFJ).
c. **Applicable %**. Subtract the phase-in ratio from 1.

Step 2. Find the adjusted amounts to use for the 20% of QBI and wage/property calculations by multiplying each unreduced amount by the applicable %:

a. **Adjusted QBI**. Multiply QBI by the applicable %.
b. **Adjusted wages**. Multiply wages by the applicable %.
c. **Adjusted UBIA**. Multiply UBIA by the applicable %.

Step 3. Calculate 20% of QBI and the two wage/property limitations but using the adjusted amounts:

a. **20% of QBI**. Adjusted QBI by 20%.
b. **Wage/property Method 1**. Adjusted wages × 50%.
c. **Wage/property Method 2**. Adjusted wages × 25% + adjusted UBIA × 2.5%.
d. Use the higher of Method 1 or Method 2 for the wage/property limitation.

> *Note*: When 20% of the adjusted QBI is less than the adjusted wage/property limitation, use 20% of adjusted QBI for Step 5 and disregard the reduction calculation in Step 4.

Step 4. Calculate the reduction amount:

a. Subtract the wage/property limitation from 20% of QBI.
b. **Reduction amount**. Multiply the excess by the phase-in ratio.

Step 5. **QBI deduction**. Subtract the reduction amount from 20% of QBI.

Illustration. Harry is single. He has taxable income of $180,000 and QBI of $125,000 from his SSTB. Applicable wages and UBIA are $35,000 and $10,000 respectively. Since Harry's taxable income is between the two thresholds we'll need to go through the steps to calculate his QBI deduction.

Step 1. Phase-in ratio and applicable percent.

a. $22,500 ($180,000 taxable income - $157,500 lower threshold).
b. 45% phase-in ratio ($22,500 / $50,000).
c. 55% applicable % (1 – 45%).

Step 2. Adjusted amounts.

a. $68,750 adjusted QBI ($125,000 QBI × 55%)
b. $19,250 adjusted wages ($35,000 wages × 55%)
c. $5,500 adjusted UBIA ($10,000 UBIA × 55%)

Step 3. 20% of QBI and wage/property limitations

a. $13,750 20% of QBI ($68,750 adjusted QBI by 20%)
b. $9,625 wage/property Method 1 ($19,250 adjusted wages × 50%) ✓
c. $4,950 wage/property Method 2 ([$19,250 adjusted wages × 25%] + [adjusted $5,500 UBIA × 2.5%])
d. $9,625 wage/property limitation (the higher of Method 1 or Method 2)

Step 4. Calculate the reduction amount:

a. $4,125 excess ($13,750 20% of QBI - $9,625 wage/property limitation)
b. $1,856 reduction amount ($4,125 excess × 45% phase-in ratio)

Step 5. QBI deduction

$11,894 ($13,750 20% of QBI - $1,856 reduction amount)

In this example, Harry's QBI deduction is $11,894. How does Harry's SSTB stack-up against Mabel's non-SSTB (TAX in the News September 26, 2018)? As we've pointed out many times, as long as their taxable income doesn't exceed the lower threshold, the calculations are the same. That is, they are not subject to wage/property limitations. When taxable income exceeds the upper threshold, Mabel's QBI deduction is subject to the wage/property limitation while Harry is not eligible for the QBI deduction at all.

When taxable income is between the two thresholds, Mabel's wage/property limitation is phased in using the phase-in ratio. Harry's calculation is not quite as dissimilar as it first appears. The important difference is that all the amounts needed to perform the calculations must first be reduced by the applicable percent. It is the adjusted amounts that must then be used to make the 20% of QBI and wage/property test comparisons, to calculate the reduction amount, and the QBI deduction.

QUALIFIED BUSINESS INCOME DEDUCTION – PART 6: MULTIPLE BUSINESSES AND AGGREGATION RULES

So far in our qualified business income deduction (QBID) series we've covered the following:

- Part 1: Overview (TITN August 22, 2018)—the basics of the QBID calculation, eligibility, and terminology.
- Part 2: SSTBs (TITN August 29, 2018)—types of activities considered "specified service trades or businesses" for purposes of the QBID.
- Part 3: QBI Vocabulary (TITN September 19, 2018)—terms and definitions needed to perform the QBID calculations that apply to higher income taxpayers.
- Part 4: Reductions for non-SSTBs (TITN September 26, 2018)—how the QBID is calculated for taxpayers with income from non-SSTBs.
- Part 5: Reductions for SSTBs (TITN October 10, 2018)—how the QBID is calculated for taxpayers with income from SSTBs.

In this installment we'll explain how the QBID works when taxpayers have qualified business income (QBI) from more than one business. First, let's review. The basic QBID is 20% of the taxpayer's QBI or, if smaller, 20% of the taxpayer's taxable income less net capital gain. When the taxpayer's taxable income exceeds $157,500 ($315,000 MFJ), the taxpayer must factor in a wage and property test which serves to reduce the QBID. The two elements in this test are "wages" and "unadjusted basis immediately after acquisition (UBIA)."

Multiple businesses – basic rules

In Part 3 we explained that QBI is the taxpayer's profit from each U.S. trade or business. QBI may be from a disregarded entity, such as a sole proprietorship, single-member LLC, or a farm. It may also be from a relevant passthrough entity (RPE) such as an S corporation or partnership. Generally, the QBID is calculated separately for each of the taxpayer's trades or businesses.

Example 1. Carla has QBI from an S corporation (which is an RPE) and from a single-member LLC that files a Schedule C. Her respective shares of QBI, wages, and UBIA from the RPE are $85,000, $30,000, and $70,000 respectively. QBI, wages, and UBIA from the LLC are $150,000, $0, and $10,000 respectively. Carla's taxable income is $250,000. Both businesses are non-SSTBs.

Carla's QBID from the RPE is $15,000, the smaller of:

$17,000 ($85,000 QBI × 20%), or

The larger of
$15,000 ($30,000 wages × 50%), or ✓
$9,250 [($30,000 wages × 25%) + ($70,000 UBIA × 2.5%)]

Carla's QBID from the LLC is $250, the smaller of:

$20,000 ($150,000 QBI × 20%), or

The larger of
$0 ($0 wages × 50%), or
$250 ($0 wages × 25%) + ($10,000 UBIA × 2.5%) ✓

Carla's total QBID is $15,250 ($15,000 + $250). If 20% of Carla's taxable income less net capital gain had been less than $15,250, her QBID would be limited to the lesser amount. In this example, 20% of her taxable income is $50,000 ($250,000 × 20%) so it does not factor into her deduction.

Businesses with losses

To this point in the series, every business in every example has had a profit. What happens if a business has a loss? The loss from one or more businesses (negative QBI) is allocated proportionally to businesses with profits (positive QBI). The QBI net of any loss adjustment is then used for the tentative 20% of QBI calculation for each business.

Example 2: Using the same facts as in Example 1, Carla has a third business, another single-member LLC. This business sustained a $50,000 loss. The loss must be allocated proportionally to the two businesses that have profits.

$235,000 total QBI for businesses with profits ($85,000 from RPE + $150,000 from LLC1)

36% RPE's share of total QBI ($85,000 / $235,000)
$18,085 loss allocated to RPE ($50,000 loss from LLC2 × 36%)
$66,915 QBI from RPE adjusted for loss ($85,000 QBI - $18,085 loss adjustment)

64% LLC1's share of total QBI ($150,000 / $235,000)
$31,915 loss allocated to LLC1 ($50,000 loss from LLC2 × 64%)
$23,617 QBI from LLC1 adjusted for loss ($150,000 - $23,617 loss adjustment)

The QBI amounts adjusted for the loss will then be used to calculate 20% of QBI and compare the results to the wage/property limitations. In this example 20% of the RPE's QBI adjusted for the loss is $13,383. Since this amount is *less than* 50% of the RPE's applicable wages, the QBID for the RPE is $13,383. The QBID for LLC1 is not affected by the loss allocation because it is still limited to $250 as calculated above. Carla's total QBID is $13,633 ($13,383 + $250).

Before moving on, here are a few more points to understand about losses:

- As noted earlier, in this example, Carla's QBID is not limited by her taxable income. If that limitation did apply, her taxable income would *not* be adjusted for losses. Her total QBID would be compared to 20% of taxable income less net capital gain.
- If the net of all QBI from all businesses results in an overall loss, the QBID is $0. Any remaining negative QBI is carried forward to the next year and reduces the QBI deduction for that year.
- Notice that we didn't mention anything about wages or UBIA from LLC2. That's because 20% of negative QBI is, for all intents and purposes, $0. Since the QBID is the smaller of 20% of QBI and the wage/property test, these elements are not applicable. In the next section we'll see that things work differently when taxpayers aggregate multiple businesses for the QBID calculation.

Aggregation rules

If a taxpayer qualifies and chooses to aggregate multiple businesses, QBI, wages, and UBIA amounts from each separate business are combined for the QBID calculation. In order to aggregate multiple businesses for the QBID, *all* of the following conditions must be met:

1. The same person or group of persons must own 50% or more of each business.
    - Ownership may be direct or indirect, such as an interest owned by a spouse, child, or parent. For RPE ownership use capital or profits percentages for partnerships and use stock ownership for S corporations.
2. This ownership control must exist for the majority of the taxable year.
3. *All* of the businesses must have the same taxable year (without regard to short years).
4. None of the businesses may be an SSTB.
5. At least *two* of the following must be met. The businesses must:
    - Provide products or services that are the same or customarily offered together.
    - Share facilities or significant centralized business elements, such as HR, IT, manufacturing, purchasing, accounting, etc.
    - Operate in coordination with, or reliance on one or more businesses in the group, such as supply chain interdependence.

Example 3. Using the same facts as example 2, Carla owns 75% of the RPE, which is a restaurant. LLC1 is a catering business and LLC2 is a food truck. The restaurant buys the food for the other two businesses and food for LLC1 is prepared at the restaurant. Carla's accountant handles the tax returns and other financial matters for all three businesses. Assume all of the other tests are met and Carla qualified to aggregate her three businesses. Wages and UBIA for the food truck are $25,000 and $20,000 respectively.

Carla's QBID is calculated as follows:

$185,000 combined QBI ($85,000 + $150,000 - $50,000)
$55,000 combined wages ($30,000 + $0 + $25,000)
$100,000 combined UBIA ($70,000 + $10,000 + $20,000)

$37,000 ($185,000 combined QBI × 20%)

$27,500 ($55,000 combined wages × 50%), or ✓
$16,250 [($55,000 combined wages × 25%) + ($100,000 combined UBIA × 2.5%)]

Aggregating the three businesses results in a QBID of $27,500 for the combined calculation, which is nearly twice the total QBID of $13,633 in Example 2. Here, Carla clearly benefits by aggregating her three businesses for the QBID calculation.

Keep in mind that aggregation is optional. However, taxpayers who qualify and choose to aggregate must continue to do so each year unless they no longer qualify. The taxpayer must attach an election statement to the return each year. The statement should indicate that the taxpayer is aggregating multiple businesses under Prop. Reg. §1.199A-4(c) and include the name, EIN, and description of each business, including newly acquired businesses and businesses that have ceased operations.

Taxpayers who either do not qualify to aggregate multiple businesses or choose not to do so must calculate the QBID separately for each business and allocate losses as explained earlier. For instance, going back to Example 1, suppose the S corporation was an SSTB. Because Carla's taxable income is more than the upper threshold or ceiling for a single filer, her QBID for the RPE would be $0 and the only deduction available to her would be the $250 QBID for the LLC. She would not qualify to aggregate the multiple businesses (because one of them is an SSTB) so she could not combine the separate elements to improve the QBID.

Joint and separate return considerations

Aggregation. For QBID purposes, married taxpayers filing jointly are treated as one taxpayer and, as pointed out earlier, each spouse is considered to have an indirect ownership of the other's business for the aggregation tests. For instance, using Example 3, suppose Carla was married and filed jointly with her spouse, Ralph, who owns LLC2. Assuming the same types of businesses, Carla and Ralph may choose to aggregate the three businesses for the QBID calculation if they qualify and choose to do so as per the same aggregation rules that apply to a single filer. And, just as with a single filer, if one spouse or the other owned an SSTB, or had less than a 50% ownership of a business, or a business operated on a different taxable year, then aggregation would not be possible.

Separate returns. In some instances, it may be beneficial for spouses to file separate returns. Using Example 1 facts, assume Carla has the ownership interest in the RPE, which is an SSTB, and Ralph owns the LLC, which is not an SSTB. Assume that their joint taxable income is over $415,000 but, if they file separately, Carla's taxable income is $350,000 and Ralph's is $90,000.

If Carla and Ralph file jointly, the only QBID available is the $250 QBID for Ralph's LLC. If they file separately, Carla's QBID would still be fully phased out, but Ralph would be eligible for a QBID of $18,000 (the smaller of QBI or taxable income times 20%). As he is under the $157,500 threshold for a separate filer, Ralph is not subject to the wage/property limitation and his only limitation would be his own taxable income. In this scenario, it is likely that Carla and Ralph would benefit by filing separately but before doing so they should make sure their separate taxes, even with the higher QBID, are still lower than they would be if they filed jointly.

QUALIFIED BUSINESS INCOME DEDUCTION – PART 7: RESIDENTIAL RENTAL ACTIVITIES

As we've discussed previously, qualified business income refers to the taxpayer's profits or, in some instances, losses from each U.S. trade or business. QBI may be from a relevant passthrough entity (RPE) or from a disregarded entity, including businesses which report on Schedule C or Schedule F. Would profits or losses from residential rental activities also be included in QBI? The answer is: perhaps.

We know from the proposed regulations that an activity must rise to the level of a trade or business under §162 but rather than defining the terms, this code section explains what types of expenses a trade or business may or may not deduct. Similarly, case law tells us that trade or business activity (or an individual's participation in the activity) must be regular, continuous and substantial but does not consistently apply these criteria to rental activities.

Nonetheless, there are some types of common rental situations that in nearly all cases are, or are not trades or businesses:

Rental activities that are *not* considered trades or businesses:

- Rental for less than FMV, aka a not-for-profit rental is not a trade or business due to the lack of profit motive.
- A single triple-net-lease (a lease agreement in which the tenant handles and pays for real estate taxes insurance, and maintenance) is not a trade or business due the extreme passive nature of the activity.
- A vacation home used as a personal residence is not a trade or business due to the lack of profit motive.

Rental activities that are considered trades or businesses:

- Self-rentals (i.e. rental to a commonly owned trade or business)
- A real estate professional who materially participates in the rental activity.

All other situations, including the common situation of a taxpayer with a few residential rental properties, depend on whether the taxpayer's participation in the rental activity is regular, continuous, and substantial based on facts and circumstances for the taxpayer's unique situation. Also, a rental activity (or any type of activity) may be a trade or business even if it is a passive activity. For residential rental activities, relevant factors to consider may include, but are not limited to the following:

1. The manner in which the taxpayer carries on the activity, such as the way the taxpayer keeps books and records.
2. The time and effort expended by the taxpayer or agent in carrying on the activity, such as the number of rental units and hours spent engaging in the activity.
3. The taxpayer's history of income or losses with respect to the activity.

Keep in mind that these factors have to be applied consistently. An important point to consider is that residential rental activities often result in a loss. Assuming the loss is not suspended under the passive activity rules, it will serve to lower or even eliminate the taxpayer's QBID for the year.

> **Example**: Wilbur has owned and actively managed four residential rental properties for several years. Although he has always turned a profit on his properties, and despite his expectations and best efforts, one of them had a number of problems and sustained a loss in 2018. By the end of the year though, he was back on track with a good tenant in place, repairs made, etc. and this property should once again be profitable in 2019.

> If Wilbur treats his 2018 rental activities as a trade or business, the loss from the fourth property must be allocated to the positive QBI from the other three and will lower the total QBID. Wilber cannot selectively include only the three residential rental properties with profits in his trade or business for QBI purposes and omit the property with the loss.

We expect that the Treasury Department and IRS will provide additional guidelines for rental properties in the future.

QUALIFIED BUSINESS INCOME DEDUCTION – PART 8: REVIEW AND WRAP-UP

We've come to the end of our qualified business income deduction series – for now. To conclude, we'll go back over some of our earlier points and provide some additional information about the QBID.

The basics, one more time. The QBID is a below-the-line deduction generally equal to 20% of the taxpayer's qualified business income (QBI). It is claimed on the taxpayer's individual tax return (on line 9 of Form 1040) and not on the business return. The business may be a disregarded entity, such as a sole proprietorship, a single-member LLC, or non-corporate farm. It may also be a passthrough entity such as a partnership or S corporation. A rental activity may also be eligible for the deduction if the activity rises to the level of a trade or business.

QBI is, essentially, the profit or loss from the business. It does not include capital gain, dividends, investment interest, or wages. It does include depreciation recapture which will typically be encountered when §1245 property is sold and gain attributable to depreciation is recaptured as ordinary income.

Taxable income…and taxable income. The QBID cannot be more than 20% of the taxpayer's taxable income. Here, taxable income means the taxpayer's ordinary taxable income (i.e. taxable income over net capital gain) before the QBID itself.

Other limitations apply when taxable income exceeds certain thresholds. For threshold purposes, taxable income means all taxable income, whether ordinary or capital, and again, without regard to the QBID itself.

The lower threshold amounts are $315,000 for joint filers and $157,500 for all other filers. These amounts will be adjusted for inflation after 2018. The upper threshold or ceiling amounts are $415,000 for joint filers and $207,500 for all other filers. The taxable income level between the two thresholds, up to $100,000 for joint filers and up to $50,000 for other filers, is referred to as the phase-in range.

Wage and property limitations. Once the taxpayer crosses the taxable income threshold, the QBID is further limited by a wage and property limitation. For purposes of this limitation, qualified wages are all wages paid by the business to its common law employees, including wages paid to S corporation shareholder-employees. Property refers to the unadjusted basis of the business's assets immediately after acquisition, or UBIA. Generally, UBIA means the cost basis of the assets before depreciation.

The basic wage and property limitation is equal to the larger of

1) 50% of qualified wages, or

2) 25% of qualified wages plus 2.5% of UBIA.

The limitation is applied somewhat differently for specified service trades or businesses (SSTBs) and non-SSTBs but, in either case, the QBID cannot exceed the limitation.

Non-SSTB

If taxable income is:

- Above the ceiling: the basic wage/property limitation applies.
- Between the lower threshold and the ceiling: the basic wage/property limitation phases in.

The QBID is the smaller of 20% of QBI or the applicable wage/property limitation.

SSTB

If taxable income is:

- Above the ceiling: the wage/property limitation is reduced to $0, and thus the QBID is $0.
- Between the lower threshold and the ceiling: qualified wages, UBIA, and QBI elements are all reduced; the wage/property limitation is then calculated on the reduced elements.

The QBID is the smaller of 20% of reduced QBI and the applicable wage/property limitation.

See TAX in the News September 26 and October 10, 2018, for full details of the non-SSTB and SSTB calculations.

REITs, PTPs, the combined QBID, and the bottom line. For taxpayers with real estate investment trust (REIT) dividends and publicly traded partnership (PTP) income, the QBID also includes 20% of these amounts. The REIT and PTP components are not subject to wage and property limitations. The *combined* QBID is equal to:

- 20% of QBI or, if smaller, the wage/property limitation, *plus*
- 20% of REIT dividends and PTP income.

Ultimately, the calculation circles back to the ordinary taxable income limitation. Once the combined QBID is determined, the final deduction is the smaller of the combined QBID or 20% of the taxpayer's taxable income over net capital gain.

As we stated at the outset, for many taxpayers, the QBID will simply be the smaller of 20% of QBI or 20% of ordinary taxable income. We'll have more QBID articles (including QBID questions of the week!) as more guidance is released and more issues come to light.