

# Publications

## Client Alert: 20% Deduction for Qualified Business Income of Individuals

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Beginning in 2018, an individual taxpayer generally may deduct 20% of his or her share of “qualified business income” from a U.S. trade or business operated through a partnership (including an LLC treated as a partnership for federal income tax purposes), S corporation, or sole proprietorship (including an LLC treated as a disregarded entity for federal income tax purposes) (the **QBI Deduction**). Qualified business income is the net income derived from a trade or business, excluding investment items such as capital gains or losses, dividends, and interest income (with special rules for investments in REITs and publicly traded partnerships). Qualified business income also excludes reasonable compensation received by a shareholder of an S corporation, and guaranteed payments received by a partner of a partnership. As discussed in further detail below, for individual owners with taxable income above a threshold amount: (i) the amount of the QBI Deduction is subject to a cap based upon the wages and capital of the business (the **Wage and Capital Cap**), and (ii) if the business is a “specified service trade or business” the QBI Deduction is subject to complete phase-out (the **Specified Service Phase-Out**).

### Wage and Capital Cap

For individuals with taxable income above \$157,500 (\$315,000 for married filing jointly), the QBI Deduction is subject to the Wage and Capital Cap. This cap is phased in, so that it is fully applicable to individuals with taxable income of at least \$207,500 (\$415,000 married filing jointly).

The Wage and Capital Cap limits the amount of an individual's QBI Deduction for a taxable year to the greater of:

- the individual's share of 50% of W-2 wages paid by the business during such year, and
- the individual's share of:
  - 25% of W-2 wages paid by the business during such year, *plus*

- 2.5% of the unadjusted cost basis of all depreciable property used in the business for which the depreciation period has not ended before the close of such year.

## Specified Service Phase-Out

For individuals with taxable income above \$157,500 (\$315,000 for married filing jointly), the QBI Deduction available for income from a “specified service trade or business” is subject to phase-out, so that it is entirely unavailable for individuals with taxable income of at least \$207,500 (\$415,000 married filing jointly).

A “specified service trade or business” is 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 business is the reputation or skill of one or more of its employees (other than trades or businesses involving the performance of services in engineering or architecture).

## Illustration

Individual X (single) owns a 10% interest in Partnership, and individual Y (married) owns a 50% interest in Partnership. Neither X nor Y has any taxable income other than that generated through Partnership. Partnership is on a calendar taxable year and does not conduct a specified service trade or business. In 2018, Partnership generates \$1,000,000 of qualified business income and pays \$500,000 in W-2 wages. In addition, the cost basis of all depreciable property used in the business of Partnership for which the depreciation period did not end before the end of 2018 is \$1,200,000.

X’s share of 2018 qualified business income of Partnership is \$100,000 ( $\$1,000,000 \times 10\%$ ). Because this amount is less than \$157,000, X is entitled to a 2018 QBI Deduction of \$20,000 ( $\$100,000 \times 20\%$ ).

Y’s share of 2018 qualified business income of Partnership is \$500,000 ( $\$1,000,000 \times 50\%$ ). Because this amount exceeds \$415,000, Y is fully subject to the Wage and Capital Cap. Y’s Wage and Capital Cap is the greater of (i) \$125,000 ( $\$500,000 \times 50\% \times 50\%$ ), and (ii) \$77,500 ( $\$500,000 \times 25\% \times 50\%$  plus  $\$1,200,000 \times 2.5\% \times 50\%$ ). Y’s 2018 QBI Deduction before application of the Wage and Capital Cap is \$100,000. Y is therefore entitled to a 2018 QBI Deduction of \$100,000.

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The new provision contemplates future Treasury Regulations that will address the allocation of wages and other items for purposes of calculating the QBI Deduction. Ultimately, the impact of the QBI Deduction on each taxpayer is highly individualized. Contact your Vorys attorney if you have any questions about the application of the 20% deduction for qualified business income to your business.