

A Deep Dive Analysis of the Latest Qualified Business Income Deduction

As we discussed in the sister article on this topic, Filing 2018 Business Taxes: Navigating the Tax Law Changes, no two businesses are alike and tax law changes effect each business differently. Rockland Trust Investment Management Group's resident Trust Tax Services Officer explains some finer details on the latest IRS deductions for qualified business income.

As part of the 2017 Tax Cuts and Jobs Act tax reform, eligible taxpayers may now deduct up to 20% of certain business income for pass-through businesses, also known as the Section 199A deduction. The deduction applies to qualified business income (QBI), as well as real estate investment trust dividends and publicly traded partnership income. We will focus on QBI for this article. Earlier on, the IRS issued a proposed regulation on the purpose of the deduction and recently a final regulation was released to address and clarify some of the ambiguity.

Background

For tax years beginning after December 31, 2017 and before January 1, 2026, Code Section 199A allows a deduction to non-corporate taxpayers, including trust and estate who have qualified business income from a partnership, S-Corporation, or sole proprietorship. This deduction is the lesser of (1) the sum of the "combined qualified business income amount", or (2) 20% of the excess, if any, of taxpayer's taxable income for the taxable year over the net capital gains.

The "combined qualified business income" is generally equal to the sum of 20% of qualified REIT dividends and publicly traded partnership income, plus the deductible amount for each qualified trade or business of the taxpayer, of which is the lesser of

1. 1. 20% of the taxpayer's qualified business income (QBI), or
2. 2. The greater of two W-2 wage limits (as discussed in detail below)¹

With this deduction, taxpayers who are in the highest income tax bracket can reduce certain business income from the top rate of 37% to an effective tax rate of 29.6%. Keep in mind that the 20% deduction is a reduction against taxable income, and not against adjusted gross income (AGI). Therefore, it will not reduce the calculation of certain AGI phase-out limits, as well as the Medicare surtax and/or the net investment income tax.

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¹ IRS Passive Activity and At-Risk Rules, Publication 925
(<https://www.irs.gov/pub/irs-pdf/p925.pdf>)

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What is Qualified Trade or Business?

In order to be considered QBI, a taxpayer's activity must first meet the definition of "trade or business." Section 199A regulation does not give a new classification of trade or business, it rather relies on the existing law definition, which in general, based on all facts and circumstances states that it must be demonstrated that the activity must have the primary intent of making profits in a regular, continuous and substantial basis. The QBI is the net amount of such income, gain, deduction, and loss related to the trade or business of the taxpayer.²

How Can I Determine if I Will Incur Any Deduction Limitations?

The 20% deduction on qualified trade or business is fully deductible for taxpayers with taxable income less than \$157,500 for individual filers and \$315,000 for married joint filers in 2018. These amounts are taken into account before the deduction. Limitation on the deduction starts to phase in for filers who exceed the threshold amounts. For married joint filers whose taxable income exceeds \$415,000 and single filers whose taxable income exceeds \$207,500, the limitations are completely phased in and they will no longer be eligible for the 20% deduction on their qualified trade or business income. For filers whose deduction is reduced, they can be subject to the specified service trade or business (SSTB) limitation and/or the wage and asset limitation.

What Does This Mean for a Rental Real Estate?

The IRS carved out a specific section dedicated to rental real estate as part of the final regulations of Section 199A. Notice 2019-7 addresses a safe harbor for when rental real estate activities would be deemed as a qualified business for purposes of Section 199A deduction. For the purpose of this safe harbor, interest in rental activities must be held directly or through an eligible pass-through entity (including a disregarded entity). Such interest held should have the intention of collecting rent and it may be an interest in multiple properties. Each rental property may be treated as a separate enterprise or all similar properties as a single enterprise. However, commercial and residential real estate may not be treated as the same enterprise.

There are certain requirements the IRS requests in order to meet the safe harbor provisions such as maintaining separate books and records and 250 hours or more of qualified rental services, as well as contemporaneous records, including time reports, logs. Taxpayers with multiple rental real estate properties should make careful analysis to select their enterprise. While segregating all rental properties into individual enterprises may provide more flexibility for planning purposes, it will also make it more stringent to meet the 250 hours requirement. Keep in mind that even if the rental real estate activity fails to qualify under the safe harbor provision, it may still qualify for the section 199A deduction under the trade or business.

Final Thoughts

The 2017 Tax Cuts and Jobs Act has created a fair amount of confusion in the minds of some business owners. To determine your unique qualified business income deduction can be very complex and requires a case by case analysis based on the facts and circumstances of each business. Therefore, we encourage you to speak to your tax advisor on this topic in order to get a better understanding for the qualification and deductibility of your trade or business/rental activity.

At Rockland Trust, we work with hundreds of businesses of all sizes to meet their financial goals. Check out our Learning Center at www.rocklandtrust.com/learning-center/business-resources for more helpful articles about managing a business.

² IRS.gov Regulation Documentation
(<https://www.irs.gov/pub/irs-drop/td-reg-107892-18.pdf>)