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Open letter to all clients

On December 22, the President signed into law the Tax Cuts and Jobs Act of 2017 (TCJA). TCJA is the largest tax overhaul since the 1986 Tax Reform Act and it will affect almost every individual and business in the United States. Generally, the new law goes into effect in 2018, with many of the provisions relating to individuals expiring at the end of 2025.

I'm writing to give you details on the Qualified Business Income Deduction.

Qualified Business Income Deduction Affecting Business Owners

If you are a sole proprietor, a partner in a partnership, a member in an LLC taxed as a partnership (hereafter, "partner"), or a shareholder in an S corporation, TCJA provides a new deduction for qualified business income for taxable years beginning after December 31, 2017, and before January 1, 2026. Trusts and estates are also eligible for this deduction.

The amount of the deduction is generally 20 percent of the taxpayer's qualifying business income from a qualified trade or business.

Example: In 2018, Joe receives $100,000 in salary from his job at XYZ Corporation and $50,000 of qualified business income from a side business that he runs as a sole proprietorship. Joe's deduction for qualified business income in 2018 is $10,000 (20 percent x $50,000).

The deduction for qualified business income is claimed by individual taxpayers on their personal tax returns. The deduction reduces taxable income. The deduction is not used in computing adjusted gross income. Thus, it does not affect limitations based on adjusted gross income.

The deduction is subject to several restrictions and limitations, discussed below.

Qualified Trade or Business. A qualified trade or business means any trade or business other than (1) a specified service trade or business, or (2) the trade or business of being an employee. A "specified service trade or business" is defined as any 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, including investing and investment management, trading, or dealing in securities, partnership interests, or commodities, and 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. Engineering and architecture services are specifically excluded from the definition of a specified service trade or business.

Special Rule Where Taxpayer's Income is Below a Specified Threshold. The rule disqualifying specified service trades or businesses from being considered a qualified trade or business does not apply to individuals with taxable income of less than $157,500 ($315,000 for joint filers). After an individual reaches the threshold amount, the restriction is phased in over a range of $50,000 in taxable income ($100,000 for joint filers). If an individual's income falls within the range, he or she is allowed a partial deduction. Once the end of the range is reached, the deduction is completely disallowed.

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Qualified Business Income Deduction Affecting Business Owners (continued)

"Domestic" Business Income Requirement. Must be effectively connected with the conduct of a trade or business within the United States.

Qualified Business Income. Qualified business income means the net amount of qualified items of income, gain, deduction, and loss with respect to the qualified trade or business of the taxpayer. Qualified business income does not include any amount paid by an S corporation that is treated as reasonable compensation of the taxpayer, or any guaranteed payment (or other payment) to a partner for services rendered with respect to the trade or business. Qualified items do not include specified investment-related income, deductions, or losses, such as capital gains and losses, dividends and dividend equivalents, interest income other than that which is properly allocable to a trade or business, and similar items.

Loss Carryovers. If the net amount of qualified business income from all qualified trades or businesses during the tax year is a loss, it is carried forward as a loss from a qualified trade or business in the next tax year (and reduces the qualified business income for that year).

W-2 Wage Limitation. The deductible amount for each qualified trade or business is the lesser of:

(1) 20 percent of the taxpayer's qualified business income with respect to the trade or business; or

(2) the greater of: (a) 50 percent of the W-2 wages with respect to the trade or business, or (b) the sum of 25 percent of the W-2 wages with respect to the trade or business and 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property (generally all depreciable property still within its depreciable period at the end of the tax year).

Example: Susan owns and operates a sole proprietorship that sells cupcakes. The cupcake business pays $100,000 in W-2 wages and has $350,000 in qualified business income. For the sake of simplicity, assume the business had no qualified property and that the variation of the limitation involving the unadjusted basis of such property isn't relevant. Susan's deduction for qualified business income is $50,000, which is the lesser of (a) 20 percent of $350,000 in qualified business income ($70,000), or (b) the 50 percent of W-2 wages ($50,000).

The W-2 wage limitation does not apply to individuals with taxable income of less than $157,500 ($315,000 for joint filers). After an individual reaches the threshold amount, the W-2 limitation is phased in over a range of $50,000 in taxable income ($100,000 for joint filers).

Allocation of Partnership and S Corporations Items. In the case of a partnership or S corporation, the business income deduction applies at the partner or shareholder level. Each partner in a partnership takes into account the partner's allocable share of each qualified item of income, gain, deduction, and loss, and is treated as having W-2 wages for the taxable year equal to the partner's allocable share of W-2 wages of the partnership. Similarly, each shareholder in an S corporation takes into account the shareholder's pro rata share of each qualified item and W-2 wages.

Additional Limitations on the Deduction for Qualified Business Income. This deduction for qualified business income is subject to some overriding limitations relating to taxable income, net capital gains, and other items which are beyond the scope of this letter and will not affect the amount of the deduction in most situations.