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New 20% deduction for “qualified business income” (“pass-through” income) under the TCJA

The qualified business income deduction is the significant new tax deduction taking effect in 2018 under the new tax law. It should provide a substantial tax benefit to individuals with “qualified business income” from a partnership, S corporation, LLC, or sole proprietorship. This income is sometimes referred to as “pass-through” income.

- The deduction is generally equal to 20% of your “qualified business income” (QBI) from a partnership, S corporation, or sole proprietorship, defined as the net amount of items of income, gain, deduction, and loss with respect to your trade or business. The business must be conducted within the U.S. to qualify, and specified investment-related items are not included, e.g., capital gains or losses, dividends, and interest income (unless the interest is properly allocable to the business). The trade or business of being an employee does not qualify. Also, QBI does not include reasonable compensation received from an S corporation, or a guaranteed payment received from a partnership for services provided to a partnership’s business.
- The deduction is taken “below the line,” i.e., it reduces your taxable income but not your adjusted gross income. But it is available regardless of whether you itemize deductions or take the standard deduction. In general, the deduction cannot exceed 20% of the excess of your taxable income over net capital gain. If QBI is less than zero it is treated as a loss from a qualified business in the following year.
- Rules are in place (discussed below) to deter high-income taxpayers from attempting to convert wages or other compensation for personal services into income eligible for the deduction.
- These rules involve “thresholds,” i.e. taxable income of over \$157,500 (\$315,000 for joint filers). If your taxable income is at least \$50,000 above the threshold, i.e., it is at least \$207,500 (\$157,500 + \$50,000), all of the net income from a specified service trade or business is excluded from QBI. (Joint filers would use an amount \$100,000 above the \$315,000 threshold, viz., \$415,000.) For taxable incomes that are between the threshold amounts and the \$207,500/\$415,000 amounts, the exclusion from QBI of income from specified service trades or businesses is phased in. Specified service trades or businesses are trades or businesses involving the performance of services in the fields of health, law, consulting, athletics, financial or brokerage services, or where the principal asset is the reputation or skill of one or more employees or owners.
- Additionally, for taxpayers with taxable income more than the above thresholds, there is a limitation on the amount of the deduction that is based either on wages paid or wages paid plus a capital element. Here's how it works: If your taxable income is at least \$207,500 (\$415,000 for joint filers), your deduction for QBI cannot exceed the greater of (1) 50% of your allocable share of the W-2 wages paid with respect to the qualified trade or business, or (2) the sum of 25% of such wages plus 2.5% of the unadjusted basis immediately after acquisition of tangible depreciable property used in the business (including real estate). For taxable incomes that are between the threshold amounts and the \$207,500/\$415,000 amounts, a phase-in of the limitation applies.
- Other limitations may apply in certain circumstances, e.g., for taxpayers with qualified cooperative dividends, qualified real

estate investment trust (REIT) dividends, or income from publicly traded partnerships. Other limitations may apply in certain circumstances, e.g., for taxpayers with qualified cooperative dividends, qualified real estate investment trust (REIT) dividends, or income from publicly traded partnerships.

To ensure compliance with requirements imposed by the IRS, we inform you that any tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of avoiding penalties under the Internal Revenue Code.