

QUALIFIED BUSINESS INCOME – ARE YOU ELIGIBLE FOR A 20% DEDUCTION?

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Tags

Deductions
T.C.J.A.
Qualified Business Income
("Q.B.I.")

INTRODUCTION

The Tax Cuts and Jobs Act ("T.C.J.A."), signed into law on December 22, 2017, contained several major changes with respect to individuals and entities. This article discusses a new provision allowing individuals, trusts, and other non-corporate taxpayers¹ to claim a deduction equal in amount to 20% of the "qualified business income" and certain other income from business, subject to certain ceilings.

This new provision is programmed to sunset for taxable years beginning after December 31, 2025, but it may be repealed earlier, depending on the results of the next presidential election, or extended on a rolling basis beyond the sunset date, as has happened for certain provisions in the area of Subpart F. It applies to both U.S. persons and non-U.S. persons, generally as long as the income relates to a "qualified" U.S. business.

Like many other provisions of the T.C.J.A., the qualified business income deduction was drafted with only limited public input that took place during a relatively short period of time. It clearly is designed to distinguish between businesses carried on in non-corporate form that employ many people in skilled and non-skilled positions and personal services businesses where owner-managers provide the key skill sets for generating profit. Business owners in the former group should be able to qualify for the benefit. Regrettably, business owners in the latter group tend to look like employees in this context, and it is unlikely that they will obtain the full benefit.

Aside from revealing broad policy objectives, a simple reading of the statute will shed little light on the business income that qualifies for the deduction. One reason is the drafting style of the statute, which hides important concepts in unusual ways. As a result, a full understanding of the winners and losers under this provision requires a thorough deconstruction of the statute. In order to achieve clarity, this article is written in question and answer format that logically guides the reader through the provisions and does not hide the results among new terms defined in hidden subdivisions of subsections.

ENTITLEMENT TO THE DEDUCTION

Taxpayers Entitled to the Code §199A Deduction

Q. 1: Can every taxpayer take the Code §199A deduction?

No. Only taxpayers other than C corporations can take the deduction.²

¹ Forthcoming regulations are expected to discuss the application of the provision to tiered partnership structures.

² Code §199A(a).

Q. 2: Can non-U.S. taxpayers take the Code §199A deduction?

Yes. Both U.S. and non-U.S. taxpayers can take the deduction if they otherwise qualify.

Income Benefitting from the Code §199A Deduction

Q. 3: What type of taxable income must a taxpayer generate in order to benefit from the Code §199A deduction?

Each of the following types of income may benefit from the deduction:

- Qualified cooperative dividends
- Qualified R.E.I.T. dividends
- Qualified publicly traded partnership income
- Qualified business income³

Q. 4: What is a cooperative and what are qualified cooperative dividends?

A cooperative is any organization that is exempt from tax under Code §521, which relates to farmers' cooperatives. It also includes any taxable corporation that operates on a cooperative basis and allocates amounts to patrons on the basis of the business done with or for such patrons.⁴ Examples are grain, citrus, and dairy businesses. These corporations are allowed a deduction for patronage dividends and per-unit retain allocations.

Qualified cooperative dividends are certain amounts received by patrons from cooperatives.⁵ They include a patronage dividend, any per-unit retain allocation, and any qualified written notice of allocation. In this way, the cooperative and its patrons split income: The patron is taxed on the qualified dividends received from the cooperative, and the cooperative is taxed on its taxable income in excess of qualified cooperative dividends paid.

A patron is any person with whom or for whom the cooperative association does business on a cooperative basis. A patronage dividend is an amount paid to a patron under a valid enforceable written obligation that is determined by reference to the net earnings of the cooperative organization from business done with or for its patrons. A per-unit retain allocation means any allocation to a patron with respect to products marketed for the patron where the amount is fixed. These payments are also deductible.

Q. 5: What is a R.E.I.T. and what are qualified R.E.I.T. dividends?

In broad terms, a R.E.I.T. (real estate investment trust) is a domestic corporation or association that is focused exclusively on the ownership, operation, financing, and

³ To facilitate a clear understanding of the provisions, these categories are discussed in order from simplest computations to most complex.

⁴ Code §1381(a)(2). Certain organizations are excluded from treatment as a cooperative. These include mutual savings banks and insurance companies and rural electrical and telephone companies.

⁵ Code §199A(e)(4).

“To the extent dividends are paid, the R.E.I.T. pays no tax and the shareholders are deemed to derive long-term capital gains or ordinary income.”

sale of real estate. If several conditions are met,⁶ a R.E.I.T. is entitled to deduct distributions to shareholders,⁷ and the shareholders report the dividend as having the character of the underlying earnings of the R.E.I.T. Thus, if the earnings arise from rental operations or mortgage financing operations, the dividends produce ordinary income in the hands of shareholders. On the other hand, if the earnings arise from the sale of real estate and are designated as a capital gain distribution, the distribution is taxed under rates for long-term capital gains.⁸ In this manner, a R.E.I.T. is not tax transparent, but to the extent dividends are paid, the R.E.I.T. pays no tax and the shareholders are deemed to derive long-term capital gains or ordinary income.

Qualified R.E.I.T. dividends are dividends received during the taxable year from a R.E.I.T. other than the following:⁹

- Dividends designated as capital gain dividends by a R.E.I.T. and thus benefiting from capital gain treatment, as provided for under Code §857(b)(3)
- Qualified dividend income as defined under Code §1(h)(11), which benefits from long-term capital gains tax rates for individuals rather than ordinary income rates

Thus, a qualified R.E.I.T. dividend is a dividend that arises from operating revenue of the R.E.I.T. and is taxed at ordinary income rates.

Q. 6: What is a publicly traded partnership and what is qualified publicly traded partnership income?

In general, partnerships, including limited liability companies (“L.L.C.”), are not subject to tax on their income.¹⁰ Instead, they are treated as tax transparent entities and conduits to partners.¹¹ Items of taxable or tax-exempt income, gain, loss, deduction, and credit of the partnership are taken into account by the partners in computing their income tax liability, even if no distribution is made to partners.

Certain partnerships are treated as corporations, even if no “check-the-box” election is made. These partnerships are known as “publicly traded partnerships.”¹² A partnership is a publicly traded partnership if interests in the partnership are traded on an established securities market or readily tradable on a secondary market. Typically, a partnership must have at least 100 partners to meet the readily-tradeable test.

An exception from corporate treatment is provided for certain publicly traded partnerships where 90% or more of gross income is “qualifying income.”¹³ Qualifying income is defined to include the following:

- Interest

⁶ Code §§856-860.

⁷ Code §857(b)(3)(B).

⁸ *Id.*

⁹ Code §199A(e)(3).

¹⁰ Code §701.

¹¹ Code §702(a).

¹² Code §7704(a).

¹³ Code §7704(c).

- Dividends
- Gains from the disposition of a capital asset (or of property described in Code §1231(b)) that is held for the production of income that is qualifying income
- Rents from real property
- Gains from the sale or other disposition of real property (including real estate held for sale to customers in the ordinary course of business)
- Income and gains from (i) the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or marketing of any mineral, natural resource (including fertilizer, geothermal energy, and timber), or industrial-source carbon dioxide or (ii) the transportation or storage of certain fuel mixtures, alternative fuel, alcohol fuel, or biodiesel fuel
- Income and gains from commodities, futures, options, or forward contracts with respect to such commodities (including foreign currency transactions of a commodity pool) where a principal activity of the partnership is the buying and selling of such commodities, futures, options, or forward contract

If corporate treatment is not mandated for a publicly traded partnership because it meets the 90% test, a 20% Code §199A deduction may be available for the following items:

- The net amount of the taxpayer's allocable share of each qualified item of income, gain, deduction, and loss that is effectively connected with a U.S. trade or business and included or allowed in determining taxable income for the taxable year
- Gain recognized by the taxpayer on the disposition of its interest in the partnership that is treated as ordinary income (e.g., by reason of Code §751)

Note that, as further explained in the answer to Q. 8, below, the deduction does not cover all income that would otherwise be qualified income for a publicly traded partnership. Thus, investment-type income, reasonable compensation, guaranteed payments for services, or Code §707(a) payments for services (to the extent provided in I.R.S. regulations) are excluded.

Q. 7: What is qualified business income (“Q.B.I.”)?

Q.B.I. is essentially income, gain, deduction, or loss that is effectively connected to a qualified trade or business.¹⁴ The income must be recognized and taken into account in determining taxable income for the year. For this purpose, the principles of Code §864(c) are applied when determining whether income is effectively connected with a qualified trade or business.¹⁵

Q. 8: What types of income are excluded from the definition of Q.B.I.?

Certain types of income are explicitly excluded from the definition of Q.B.I. They fall into three broad categories.

¹⁴ Code §199A(c)(3)(A).

¹⁵ Code §199A(c)(3)(A)(i).

Items in the first category are covered elsewhere and may qualify for the deduction based on their own tests:

- Qualified cooperative dividends¹⁶
- Qualified R.E.I.T. dividends¹⁷
- Qualified publicly traded partnership income¹⁸

Items in the second category relate broadly to investment income and gains:

- Any short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss¹⁹
- Any dividend, income equivalent to a dividend, or payment in lieu of dividends described in Code §954(c)(1)(G)²⁰
- Any interest income other than interest income that is properly allocable to a trade or business²¹
- Any item of gain or loss relating to certain commodities transactions or foreign currency gains²²
- Any item of income, gain, deduction, or loss relating to currency gains and losses that are not considered to be hedges of business-related currency risks²³
- Any amount received from an annuity which is not received in connection with the trade or business²⁴
- Any item of deduction or loss properly allocable to a previously described amount²⁵

Items in the third category relate broadly to compensation arrangements involving a business conducted as an S-corporation or partnership, including an L.L.C.:

- Reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business²⁶
- Any guaranteed payments to a partner for services rendered with respect to



¹⁶ Code §199A(c)(1).

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ Code §199A(c)(3)(B)(i).

²⁰ Code §199A(c)(3)(B)(ii).

²¹ Code §199A(c)(3)(B)(iii).

²² Code §199A(c)(3)(B)(iv).

²³ Code §199A(c)(3)(B)(v).

²⁴ Code §199A(c)(3)(B)(vi).

²⁵ Code §199A(c)(3)(B)(vii).

²⁶ Code §199A(c)(4)(A).

the trade or business²⁷

- To the extent provided in regulations, any payment described in Code §707(a) to a partner not acting in its capacity as partner for services rendered with respect to the trade or business²⁸

Definition of Qualified Trade or Business

Q. 9: What is a qualified trade or business?

A qualified trade or business is any trade or business other than (i) the trade or business of performing services as an employee or (ii) the performance of a specified service trade or business (“S.S.T.B.”).²⁹

Q. 10: How is an employee distinguished from an independent contractor that is conducting a business?

There are several areas of tax law in which the status of an individual as an employee or independent contractor must be determined in order to arrive at a proper tax result. In the international tax field, the distinction may control whether a permanent establishment exists when the individual is providing services to a resident of a country with which the U.S. has an income tax treaty. It also may control whether an individual resident of that country is taxed on compensation income from the performance of services in the U.S. In the domestic context, the determination controls whether the person paying the compensation must withhold income and social security taxes from payments.

While the domestic fact pattern is much more mundane than the cross-border complexities of treaties and permanent establishments, the rules are relatively well developed and I.R.S. guidance exists. Moreover, in the domestic context, the payer is based in the U.S. and has its own obligations and its own exposure to noncompliance penalties. Hence, the domestic rules distinguishing between an employee and an independent contractor likely provide helpful guidance until such time as I.R.S. regulations are published. When regulations are published, they may follow to a greater or lesser extent existing rules regarding employer withholding obligations in the domestic context.

Section 2 of I.R.S. Publication 15-A, *Employer’s Supplemental Tax Guide*, addresses the question of whether a service provider is an employee or an independent contractor. It provides the following view of the I.R.S., beginning on page 7:

Common Law Rules

To determine whether an individual is an employee or an independent contractor under the common law, the relationship of the worker and the business must be examined. In any employee-independent contractor determination, all information that provides evidence of the degree of control and the degree of independence must be considered.

Facts that provide evidence of the degree of control and independence

²⁷ Code §199A(c)(4)(B).

²⁸ Code §199A(c)(4)(C).

²⁹ Code §199A(d)(1).

fall into three categories: behavioral control, financial control, and the type of relationship of the parties. These facts are discussed next.

Behavioral control. Facts that show whether the business has a right to direct and control how the worker does the task for which the worker is hired include the type and degree of: Instructions that the business gives to the worker.

Instructions that the business gives to the worker. An employee is generally subject to the business' instructions about when, where, and how to work. . . . The amount of instruction needed varies among different jobs. Even if no instructions are given, sufficient behavioral control may exist if the employer has the right to control how the work results are achieved. . . .

Training that the business gives to the worker. An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods.

Financial control. Facts that show whether the business has a right to control the business aspects of the worker's job include:

The extent to which the worker has unreimbursed business expenses. Independent contractors are more likely to have unreimbursed expenses than are employees. Fixed ongoing costs that are incurred regardless of whether work is currently being performed are especially important. . . .

The extent of the worker's investment. An independent contractor often has a significant investment in the facilities or tools he or she uses in performing services for someone else. . . .

The extent to which the worker makes his or her services available to the relevant market. An independent contractor is generally free to seek out business opportunities. Independent contractors often advertise, maintain a visible business location, and are available to work in the relevant market.

How the business pays the worker. An employee is generally guaranteed a regular wage amount for an hourly, weekly, or other period of time. This usually indicates that a worker is an employee, even when the wage or salary is supplemented by a commission. . . .

The extent to which the worker can realize a profit or loss. An independent contractor can make a profit or loss.

Type of relationship. Facts that show the parties' type of relationship include:

- ***Written contracts describing the relationship the parties intended to create.***
- ***Whether or not the business provides the worker with employee-type benefits, such as insurance, a pension plan,***



vacation pay, or sick pay.

- ***The permanency of the relationship. . . .***
- ***The extent to which services performed by the worker are a key aspect of the regular business of the company.***

Other more practical indicia of running a business rather than being an employee include the following:

- Business stationary with a mailing address, e-mail domain name, and telephone number that have no connection to those of the client
- Using the foregoing contact points in written, digital, and telephonic correspondence with the client
- Paying health insurance premiums for coverage that is not part of the client's group insurance plan
- Terminating participation in the client's pension plan and establishing a separate self-employed pension plan that is totally funded by the service provider
- Having more than one client or multiple clients that are all commonly owned or related
- Purchasing equipment, computer programs, and data base access that are used to provide services to the client
- Obtaining an I.R.S. employer identification number for the business

Q. 11: What is the definition of an S.S.T.B.?

S.S.T.B. is the term used to describe persons who are not employees and who principally practice a consulting service or profession. Depending on the circumstances, these persons can operate from a small independent base or a large, global organization. The definition of S.S.T.B. is based on the definition of "qualified trade or business" for purposes of the qualified small business stock exclusion of Code §1202.³⁰ Under that Code section, if the business (i) is a qualified trade or business, (ii) is carried on in corporate form, and (iii) meets certain tests, individual shareholders are allowed an exclusion when shares of the corporation's stock are sold at a gain.³¹ For purposes of the Q.B.I. deduction, the following qualified trades or businesses for purposes of Code §1202 constitute S.S.T.B. if they are carried on as a sole proprietorship, partnership, or S-corporation:³²

- Health
- Law
- Accounting

³⁰ See discussion in ["Qualified Small Business Stock & the EB-5 Visa Program – An Attractive Combination for Potential Investors," Insights 6 \(2017\).](#)

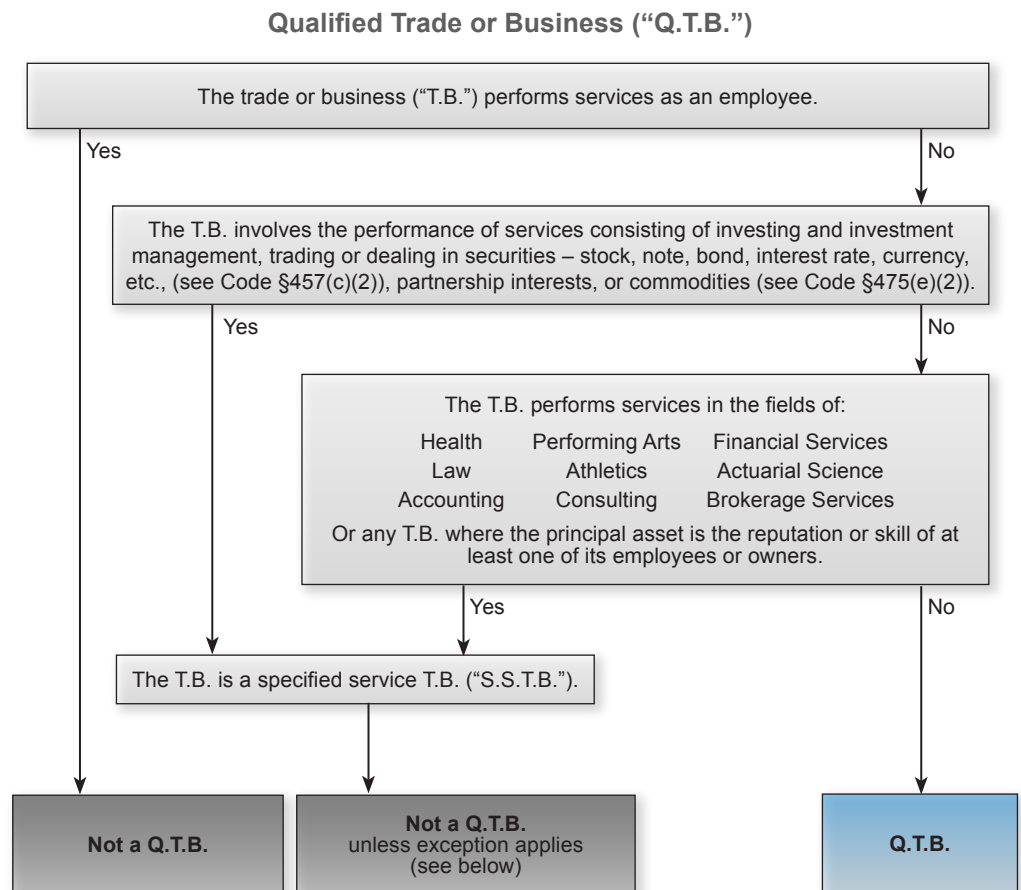
³¹ Code §1202(a) provides the exclusion. Code §1202(e)(3) lists businesses that are characterized as qualified trades or businesses. These businesses are similar but not identical to those listed under Code §199A.

³² Engineering and architectural services are listed in Code §1202(e)(3) but are removed from categorization as S.S.T.B.'s.

- Actuarial science
- Performing arts
- Consulting
- Athletics
- Financial services
- Brokerage services
- Any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees³³

Also included as S.S.T.B.'s are service businesses that consist of investing and investment management trading or dealing in securities, partnership interests, or commodities, which typically must use a mark-to-market accounting method that results in gain recognition if the value of the securities inventory appreciates as of the close of the year.³⁴

The following flowchart illustrates the definitions of qualified trade or business and S.S.T.B.



³³ A business that takes into account the reputation or skill of the owners in addition to employees does not appear in the list under Code §1202(e)(3).

³⁴ Code §475.

“A trade or business would not be a qualified trade or business when (i) the owner has a skillset that is brought to the business and (ii) the skillset itself is not unique to the owner but (iii) the reputation for quality is unique and is valued by the customers.”

Q. 12: Does Code §199A provide an explanation as to when the principal asset of a trade or business is the reputation or skill of one or more of its employees?

No. However, the reference by Code §199A(d)(2)(A) to Code §1202(e)(3)(A), relating to qualified small business stock, coupled with the absence of guidance under Code §199A, should allow taxpayers to usefully rely on guidance issued under Code §1202(e)(3)(A). The same standard should apply to owners of the business carried on as a sole proprietorship, partnership, or S-corporation.

In Private Letter Ruling 201717010 (the “P.L.R.”),³⁵ a C-corporation (the “Taxpayer”) provided laboratory results to clients in the healthcare industry. The Taxpayer’s employees were trained for up to a year to perform the testing upon which the laboratory results were based. The skills the employees brought with them at the time they were hired by the Taxpayer were of almost no use when performing the testing activities. Further, the skills the employees acquired were unique to the work they performed for the Taxpayer and of no use to other employers. The I.R.S. thus concluded that the Taxpayer was not in a trade or business where the principal asset of the trade or business is the reputation or skill of one or more of its employees.

Until regulations or other guidance are issued by the I.R.S., this fact pattern may prove useful if the references to employees are broadened to include owners of a business and the references to other employers are broadened to include customers.

By extrapolation, a trade or business would not be a qualified trade or business when (i) the owner has a skillset that is brought to the business and (ii) the skillset itself is not unique to the owner but (iii) the reputation for quality is unique and is valued by the customers. While such a business would not be a qualified trade or business, it may be an S.S.T.B. and still give rise to a limited deduction as explained below.

Q. 13: For purposes of Code §199A, why is it not always bad for a business to be categorized as an S.S.T.B.?

While it is better, for the purposes of the deduction, for an individual to conduct a qualified trade or business, conducting an S.S.T.B. may still allow an individual a limited Code §199A deduction based on a simplified formula. This limited deduction is available up to a threshold amount and is discussed below.

COMPUTATION OF THE DEDUCTION

In General

Q. 14: How is the Q.B.I. deduction computed?

Until the I.R.S. publishes regulations or other guidance, the best way to understand the computation of the Q.B.I. deduction is to deconstruct the statute, giving attention to each element of the deduction. The sum of these elements is the amount of the deduction.

³⁵

PLR 201717010, 04/28/2017.

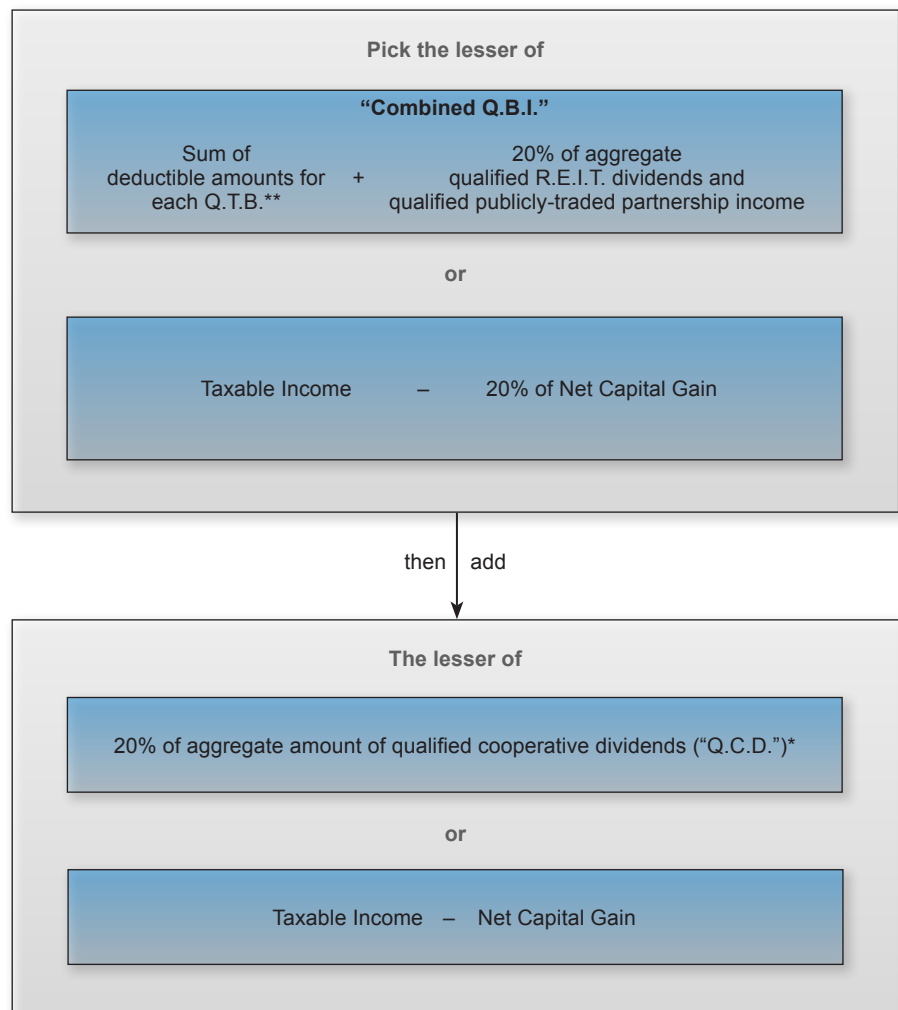
Q. 15: What elements comprise the Code §199A deduction?

As mentioned above, four separate streams of income can result in the Code §199A deduction:

- Qualified cooperative dividends
- Qualified R.E.I.T. dividends
- Qualified publicly traded partnership income
- Q.B.I.

Each is discussed separately, and the following diagram is a useful reference for purposes of understanding the deduction.

Qualified Business Income Deduction



* Paid by certain tax exempt entities and cooperatives under subchapter T.

** See next diagram

Qualified Cooperative Dividends

Q. 16: In general, how is the Code §199A deduction for qualified cooperative dividends computed?

As discussed above, qualified cooperative dividends consist of patronage dividends, any per-unit retain allocations, and any qualified written notice of allocations. The amount of the Code §199A deduction for these items is 20% of the amount received, capped at the taxpayer's taxable income, net of capital gains.³⁶ When the deduction for qualified cooperative dividends is added to combined Q.B.I., the total deduction is capped by the individual's taxable income for the year, excluding net capital gains. This is discussed below in greater detail.

Q. 17: If, after paying qualified cooperative dividends to patrons, a cooperative has taxable income, is the cooperative entitled to a Code §199A deduction?

Yes. A special rule exists for specified agricultural and horticultural cooperatives under which a Code §199A deduction may be claimed by the cooperative. This type of cooperative may deduct 20% of the amount by which its gross income exceeds qualified cooperative dividends paid during the year.³⁷

However, the deduction is capped at the greater of 50% of the W-2 wages of the cooperative with respect to its trade of business or 25% of the W-2 wages plus 2.5% of the unadjusted basis, immediately after acquisition, of all qualified property of the cooperative.

Q. 18: What cooperatives are entitled to claim the Code §199A deduction?

A cooperative is entitled to claim the Code §199A deduction if it is a specified agricultural or horticultural cooperative. This means that it is a taxable cooperative under the rules of Subchapter T of the Code and is engaged in any of the following businesses:

- The manufacture, production, growth, or extraction in whole or significant part of any agricultural or horticultural product
- The marketing of agricultural or horticultural products that its patrons have manufactured, produced, grown, or extracted
- The provision of supplies, equipment, or services to farmers or to organizations described in the foregoing bullet points³⁸

Qualified R.E.I.T. Dividends

Q. 19: In general, how is the Code §199A deduction relating to qualified R.E.I.T. dividends determined?

The rules covering the deduction for qualified R.E.I.T. dividends appear in the

³⁶ Code §199A(a)(2).

³⁷ Code §199A(g)(1)(A).

³⁸ Code §199A(g)(3).

“The deduction for combined Q.B.I. and qualified cooperative dividends cannot exceed the taxpayer’s taxable income for the year, computed by excluding net capital gain.”

definition of the term “combined Q.B.I. amount.”³⁹

The Code §199A deduction for qualified R.E.I.T. dividends is 20% of the amount of the qualified dividend received by the shareholder. As discussed previously in the answer to Q. 5, qualified R.E.I.T. dividends do not include capital gain dividends paid by the R.E.I.T. and dividends that are covered by Code §1(h)(11).⁴⁰ Both those dividends are taxed at favorable long-term net capital gains tax rates.

In the first instance, no cap is placed on the amount of the deduction. However, when 20% of qualified R.E.I.T. dividends are added to the sum of the deductible amounts for each qualified trade or business and to 20% of qualified publicly traded partnership income to arrive at combined Q.B.I. amount, as discussed below, the deductible amount cannot exceed 20% of the taxable income of the taxpayer for the year. This cap is computed without taking into account net capital gain income and qualified cooperative dividends.

As alluded to above and discussed in more detail below, the deduction for combined Q.B.I. and qualified cooperative dividends cannot exceed the taxpayer’s taxable income for the year, computed by excluding net capital gain.⁴¹

Qualified Publicly Traded Partnership Income

Q. 20: In general, how is the Code §199A deduction for qualified publicly traded partnership income determined?

The rules covering the deduction for publicly traded partnership income appear in the definition of the term “combined Q.B.I. amount,” which supplements the general definition provision of Code §199A.⁴²

As discussed in the answer to Q. 6, a publicly traded partnership is generally treated as a corporation for U.S. income tax purposes unless 90% or more of its gross income is qualifying income.

Several categories of income can be qualifying income, including interest; dividends; certain gains; rents from real property; gains from the sale or other disposition of real property; income and gains from the exploration, development, mining, or production of natural resource; and income and gains from commodities or futures contracts and the like.

In computing the Code §199A deduction relating to qualified publicly traded partnership income, only the partnership’s Q.B.I. (as defined in the answer to Q. 7) is taken into account. Concepts of effectively connected income are used to determine how much of the partnership income is qualified. Passive income and compensation-related income are excluded when computing the deduction.

When the qualified publicly traded partnership income is determined, 20% of that amount is added to 20% of the aggregate qualified R.E.I.T. dividends, discussed

³⁹ Code §199A(g)(1)(B).

⁴⁰ Code §199A(e)(3).

⁴¹ Code §199A(a), last sentence.

⁴² Code §199A(b)(1)(B) and (e)(5).

above, and to the deductible amount for each qualified trade or business, discussed below, to arrive at the combined Q.B.I. amount. As alluded to above, when the combined Q.B.I. amount is added to the deduction for the qualified cooperative dividend, the aggregate deduction cannot exceed the taxable income of the taxpayer for the year. Again, the cap is computed by excluding net capital gain income and qualified cooperative dividends.

Q.B.I.

Q. 21: In general, how is the part of the Code §199A deduction relating to Q.B.I. computed?

This part of the Code §199A deduction is referred to in the Code as “the deductible amount for each qualified trade or business” (“D.A.Q.T.B.”). For simplicity, this article uses the term “Tentative Q.B.I. Deduction.”

For each qualified trade or business, the deduction is computed in several steps.⁴³ The initial step is straightforward. The Q.B.I. for each business is multiplied by 20%, and the result is the Tentative Q.B.I. Deduction. Then, limitations are applied to this result. These limitations are designed to ensure that the deduction benefits an active trade or business with substantial headcount or long-term investment in property, plant, and equipment.

The first limitation subjects the amount of the deduction to two ceilings.⁴⁴ One is based on wages paid. The other only applies if the first ceiling is exceeded.

Under the first ceiling, the Q.B.I. deduction cannot exceed 50% of the W-2 wages paid with respect to the qualified trade or business. This is beneficial for a labor-intensive business.

Under the second ceiling, the deduction cannot exceed the sum of (i) 25% of the W-2 wages paid with respect to the qualified trade or business plus (ii) 2.5% of the unadjusted basis of all qualified property immediately after acquisition. Stated differently, the latter amount is 2.5% of the all-in cost of the property, based on a snapshot on the date of acquisition. Qualified property consists of property, plant, and equipment held at the close of the taxable year and for which the depreciable period has not ended before the close of the year. The depreciable period cannot exceed ten years from the date the property was first placed into service by the taxpayer.⁴⁵ This second ceiling is beneficial to a capital-intensive business. Accelerated write-off provisions enacted as part of T.C.J.A. will not reduce the benefit under this ceiling.

Additional limitations apply to the way the Tentative Q.B.I. Deduction interplays with the first and second ceiling amounts. These limitations are discussed later in this article under Q. 23.

The following flowchart illustrates the two ceilings.

⁴³ Code §199A(a).

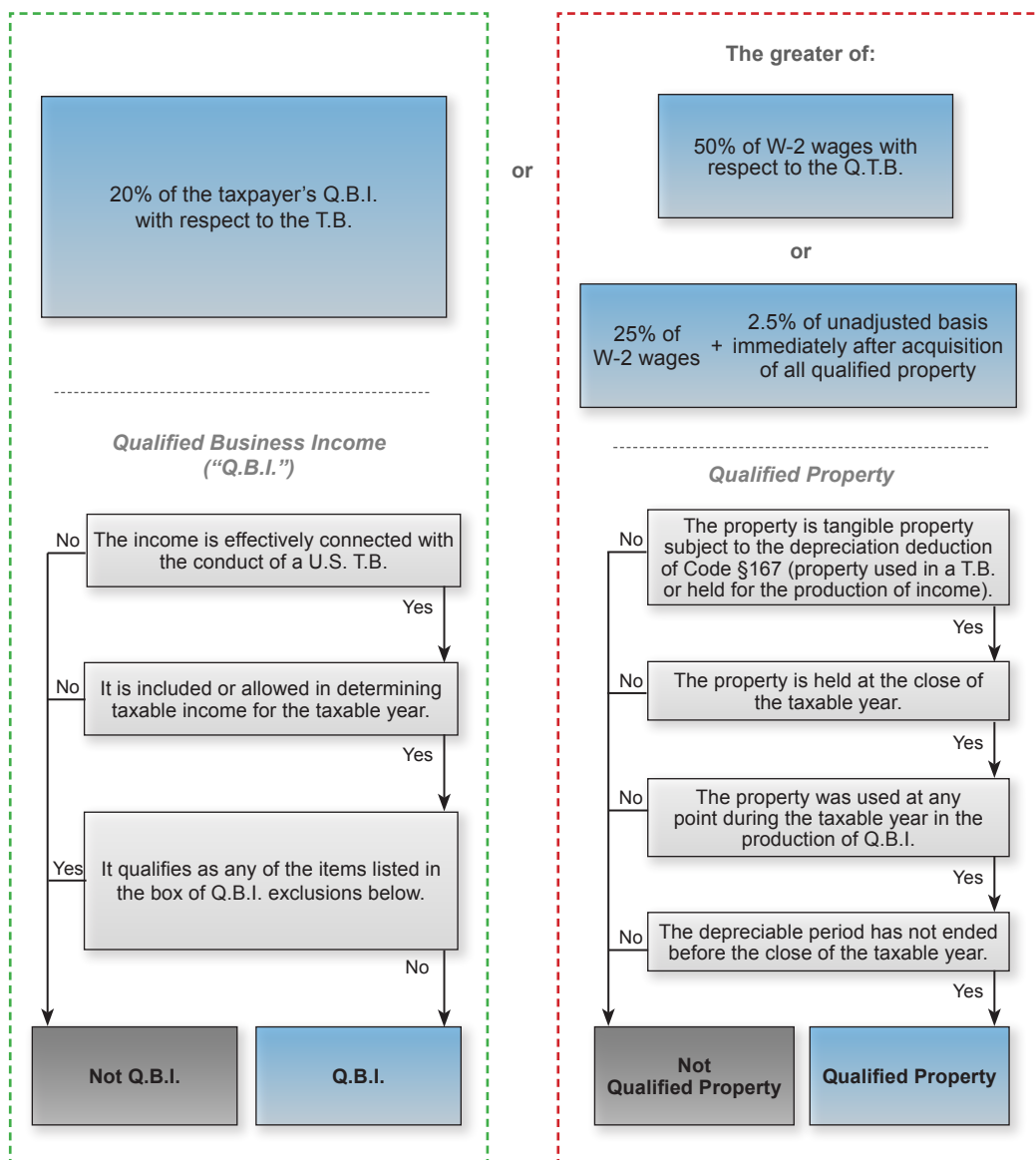
⁴⁴ Code §199A(b)(2)(B)

⁴⁵ Code §199A(b)(6).



Deductible Amount for Each Q.T.B. ("D.A.Q.T.B.")

The deductible amount is the lesser of:



Q.B.I. Exclusions

- Qualified R.E.I.T. dividends
- Qualified cooperative dividends
- Qualified publicly traded partnership income
- Any short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss
- Any dividend, income equivalent to a dividend, or payment in lieu of dividends described in Code §954(c)(1)(G)
- Any interest income other than interest income which is properly allocable to a trade or business
- Any item of gain or loss relating to certain commodities transactions or foreign currency gains
- Any item of income, gain, deduction, or loss relating to certain notional principal contracts
- Any amount received from an annuity which is not received in connection with the trade or business
- Any item of deduction or loss properly allocable to a previously described amount
- Reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business
- Any guaranteed payments to a partner for services rendered with respect to the trade or business
- To the extent provided in regulations, any payment described in Code §707(a) to a partner not acting in capacity as partner for services rendered with respect to the trade or business

At this point, a third limitation (mentioned several times above) comes into play. The qualified R.E.I.T. dividends and qualified publicly traded partnership income, if any, are added to the capped Q.B.I. deduction to arrive at the combined Q.B.I. amount. The sum of the deductions for combined items is then capped so that it cannot exceed 20% of the taxable income of the taxpayer for the year, computed by excluding net capital gain income plus qualified cooperative dividends.⁴⁶

Finally, the fourth limitation is applied. The deduction for the combined Q.B.I. amount and 20% of the qualified cooperative dividends⁴⁷ cannot exceed, in the aggregate, the taxpayer's taxable income for the year, net of capital gains.⁴⁸

Q. 22: Do all wages qualify as W-2 wages?

No. W-2 wages are defined as follows:

- The wages must constitute remuneration paid for services performed by an employee for the benefit of the employer with respect to employment during the calendar year (as defined in Code §3401(a)) or certain employee retirement fund payments (as defined in Code §§402(g)(3), 457, 402A) with respect to employment during the calendar year.⁴⁹
- The wages must be reported to the Social Security Administration on a Form W-2, *Wage and Tax Statement*, and Form W-3, *Transmittal of Wage and Tax Statements*.⁵⁰
- The Forms W-2 and W-3 reporting such wages must be filed by the 60th day after the due date (including extensions) for such returns.⁵¹ This requirement essentially encourages taxpayers to pay close attention to their employment tax compliance. Most importantly, it encourages employers to (i) determine precisely what payments constitute wages for employment tax purposes and (ii) properly differentiate between independent contractors and employees. Any long-term non-compliance may adversely affect the taxpayer's Q.B.I. deduction.
- The wages must be allocable to qualified business income.⁵²
- The wages cannot constitute any of the following:⁵³
 - Reasonable compensation paid to the taxpayer by any S-corporation that is a qualified trade or business of the taxpayer for services

⁴⁶ Code §199A(a)(1).

⁴⁷ Capped by the taxpayer's taxable income net of capital gains.

⁴⁸ Code §199A(a), last sentence.

⁴⁹ Code §199A(b)(4)(A).

⁵⁰ Code §199A(b)(4)(C).

⁵¹ *Id.*

⁵² Code §199A(b)(4)(B).

⁵³ Code §199A(b)(4)(B) as referencing to Code §199A(c)(1) and Code §199A(c)(4) for the definition of "qualified business income" of Code §199A(c)(1).

rendered with respect to the trade or business⁵⁴

- Any guaranteed payments to a partner for services rendered with respect to the trade or business⁵⁵
- To the extent provided in regulations, any payment described in Code §707(a) to a partner not acting in its capacity as a partner for services rendered with respect to the trade or business⁵⁶

The following example illustrates the computations and limitations:

- Mrs. X is the sole owner of X L.L.C., which manufactures widgets for sale. X L.L.C. employs several employees and pays them wages in an aggregate amount of \$800,000. X L.L.C. has ordinary income of \$5,000,000, and the machinery and other property used in its business has an unadjusted basis of \$2,000,000 at the time of purchase and a depreciable life greater than ten years. Further, Mrs. X has no qualified cooperative dividends, qualified R.E.I.T. dividends, qualified publicly traded partnership income, or net capital gain.
- Mrs. X is entitled to a deduction computed as follows:
 - Tentative Deduction: 20% of her taxable income attributable to the Q.B.I. of X L.L.C. = \$1,000,000⁵⁷
 - First Ceiling Amount: 50% of the W-2 wages = \$400,000⁵⁸
 - Second Ceiling Amount: 25% of the W-2 wages (\$200,000)⁵⁹ + 2.5% of the unadjusted basis of property (\$50,000)⁶⁰ = \$250,000
- Mrs. X is thus entitled to a deduction of \$400,000 (*i.e.*, the amount of the Tentative Q.B.I. Deduction capped at the greater of the first and second ceiling amounts).

Additional Limitations

Q. 23: What are the additional limitations that apply when computing the Code §199A deduction relating to Q.B.I.?

Individuals who are not employees under the standard set forth above can benefit from the Code §199A deduction in a relatively uncomplicated way if their taxable income does not exceed a certain threshold.

For persons who are unmarried, an S.S.T.B. entrepreneur can claim the full 20%

⁵⁴ Code §199A(c)(4)(A).

⁵⁵ Code §199A(c)(4)(B).

⁵⁶ Code §199A(c)(4)(C).

⁵⁷ \$5,000,000 x 20%

⁵⁸ 50% x \$800,000

⁵⁹ 25% x \$800,000

⁶⁰ 2.5% x 2,000,000

“As the taxpayer’s income increases within the clawback corridor, more and more of the benefit of the 20% Q.B.I. deduction is lost.”

Tentative Q.B.I. Deduction,⁶¹ provided that taxable income does not exceed a threshold amount.⁶² Consequently, as long as the individual’s total taxable income is within the threshold amount, the ceilings based on (i) 50% of W-2 wages or (ii) 25% of W-2 wages and 2.5% of capital investment in property, plant, and equipment are not applicable. For such individuals, the threshold amount is \$157,500 of total taxable income reported in an unmarried individual’s tax return.

If the individual is married and files a joint return with a spouse, the threshold amount is \$315,000. Again, the individual’s business must not be characterized as employment based on the standards described the answer to Q. 10. The threshold amount is adjusted annually for inflation.

Once the threshold amount is breached, Code §199A benefits under the simplified method for those with taxable income under the threshold are clawed back on a ratable basis over a specified range. The intent is to eliminate the benefit of the simplified method entirely when the clawback range is fully used.

For an unmarried individual with taxable income in excess of \$157,500, the entire benefit is clawed back on a ratable basis as total taxable income reaches \$207,500. The clawback range is \$50,000.

If the individual is married, the clawback begins when total taxable income exceeds \$315,000, and the entire benefit is eliminated when total taxable income reaches \$415,000 in the joint return. The clawback range for married individuals is \$100,000.

As the taxpayer’s income increases within the clawback corridor, more and more of the benefit of the 20% Q.B.I. deduction is lost. When income reaches the top of the corridor, the ceilings apply in full, achieving the same result as if the ceilings would have been applied in the first place.

The clawback is determined by reducing the Tentative Q.B.I. Deduction by the amount obtained using the following formula:

$$\left(\begin{array}{cc} \text{Tentative} & \text{First or Second} \\ \text{Q.B.I. Deduction} & \text{Ceiling} \end{array} - \right) \times \frac{\text{Taxable Income} - \$157,500}{\$50,000}$$

Q. 24: How does the clawback formula work in an actual fact pattern?

The clawback is illustrated in the following examples.

Example 1

- Mrs. X, a married individual filing a joint income tax return with her spouse, Mr. X, is the sole owner of X L.L.C., a manufacturer of widgets. X L.L.C. employs two individuals and pays total wages of \$50,000. X L.L.C. has ordinary taxable income of \$300,000, and the machinery and other property used in its business has an unadjusted basis of \$20,000. Mrs. X has no qualified

⁶¹ Code §199A(b)(3)(A).

⁶² Code §199A(b)(3)(B).

cooperative dividends, qualified R.E.I.T. dividends, qualified publicly traded partnership income, or net capital gain. Mr. X has no income.

- Mrs. X's threshold amount is \$315,000, since she is filing a joint tax return with her spouse. Mrs. X's taxable income is below the income threshold, and she is entitled to a deduction computed as follows:
 - Tentative Deduction: 20% of the \$300,00 taxable income attributable to the Q.B.I. of X L.L.C. = \$60,000
 - First Ceiling Amount: 50% of the \$50,000 of W-2 wages = \$25,000
 - Second Ceiling Amount: 25% of the \$50,000 of W-2 wages (\$12,500) + 2.5% of the unadjusted basis of property (\$500) = \$13,000
- Mrs. X is entitled to a deduction of \$60,000 under the simplified method, because the ceilings do not apply. Were they applicable, her deduction would have been \$25,000. As a result, the benefit of the simplified method is \$35,000.

Example 2

- Across the street from the widget premises of X L.L.C., Mr. Y maintains a shop, Y L.L.C., that manufactures super widgets. Y L.L.C. has two employees who are paid wages in an aggregate amount of \$50,000. Y L.L.C. has ordinary taxable income of \$300,000, and the machinery and other property used in its business has an unadjusted basis of \$20,000. Further, Mr. Y has no qualified cooperative dividends, qualified R.E.I.T. dividends, qualified publicly traded partnership income, or net capital gain. Additionally, Mrs. Y is a kindergarten teacher with an annual salary of \$100,000.
- Mr. Y's threshold amount is \$315,000, since he is filing a joint return with his spouse. Mr. Y's upper phase-in limit is \$415,000 (*i.e.*, \$315,000 + \$100,000).
- Because Mr. Y's income is within the clawback corridor, Mr. Y is entitled to a deduction computed as follows:
 - Tentative Deduction: 20% of the \$300,000 taxable income attributable to the Q.B.I. of X L.L.C. = \$60,000
 - First Ceiling Amount: 50% of the \$50,000 of W-2 wages = \$25,000
 - Second Ceiling Amount: 25% of the \$50,000 of W-2 wages (\$12,500) plus 2.5% of the unadjusted basis of property (\$500) = \$13,000
- Mr. Y would have been entitled to a deduction of \$60,000 had the total taxable income on his tax return been under \$315,000. However, because his total taxable income exceeds the threshold but not the \$100,000 clawback corridor, his deduction is equal to \$25,000 under the first ceiling plus a portion of the \$35,000 difference between the \$60,000 Tentative Q.B.I. Deduction and the \$25,000 amount under the first ceiling.
- Mr. Y's total taxable income exceeds the threshold amount by \$85,000 (*i.e.*,

\$400,000 - \$315,000). Applying the formula described above, the \$35,000 benefit for being under the threshold is multiplied by a fraction to determine the clawback:

- $\$35,000 \times (\$85,000 \div \$100,000) = \$ 29,750$
- The remainder of \$5,250 is added to \$25,000, and the Code §199A deduction under the phaseout is \$30,250.

S.S.T.B.

Q. 25: What benefit is derived when an individual who is not an employee is engaged in an S.S.T.B.?

When an individual who is not an employee is engaged in an S.S.T.B., he or she may be eligible for the Q.B.I. deduction on a simplified basis, provided that income remains at a relatively low level.

In principle, logical consistency suggests that a highly successful individual who is engaged in a consulting business would not be someone whose net income is relatively low. While a successful businessperson can hire staff, employ people, and maximize W-2 wage income, providing that person with a tax break may not be good politics.

On the other hand, providing a *sub rosa* tax break to someone beginning a consulting business who scrapes to make ends meet while following his or her dream likely has wider political appeal. Thus, the logic may be bad in respect of the Q.B.I. deduction, but the politics are good.

First, the individual's taxable income must be above the specified amount but not in excess of the high end of the clawback corridor. Second, the Tentative Q.B.I. Deduction and the two ceiling amounts are reduced by the following percentage:

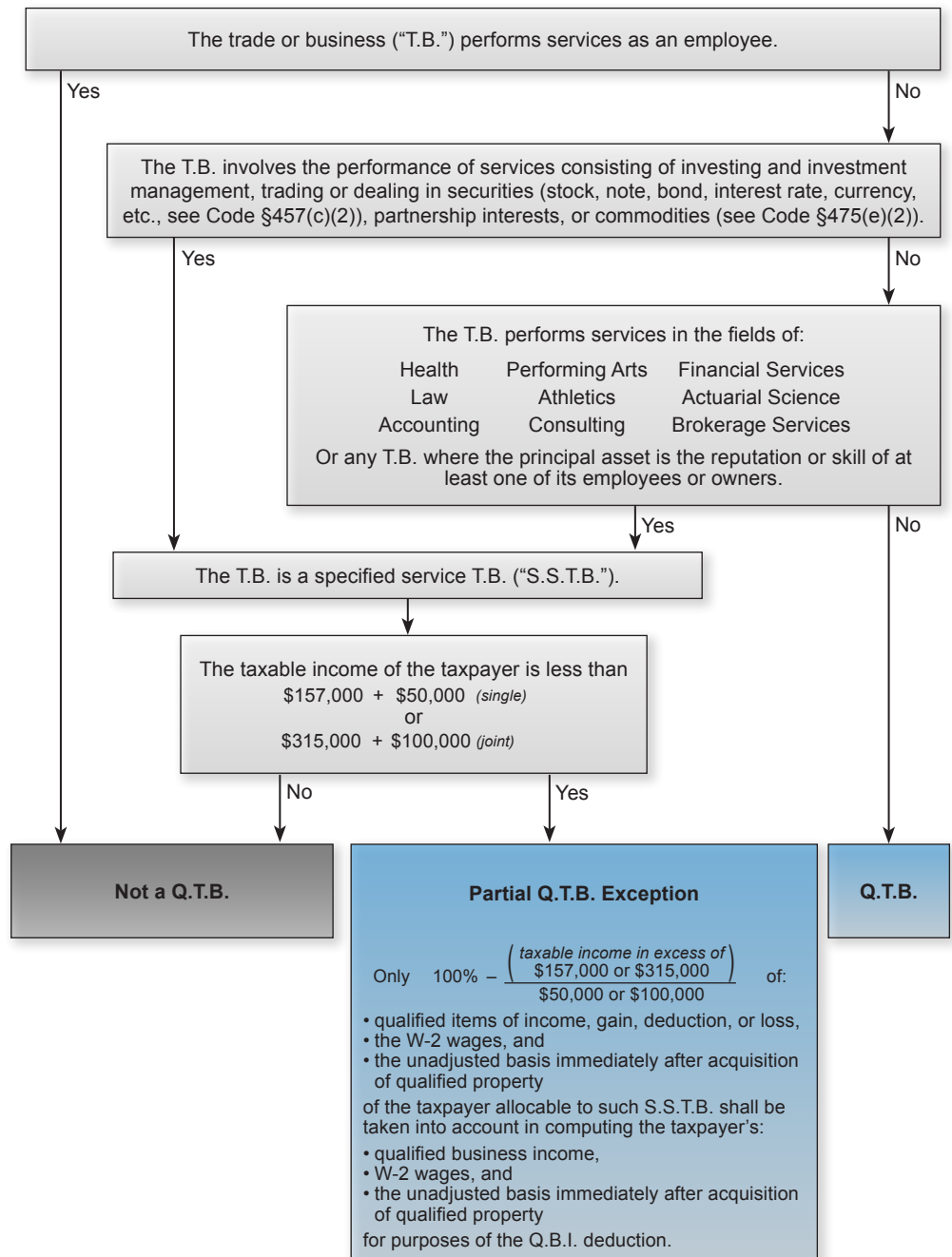
$$100\% - \left(\frac{\text{the amount of income actually within the clawback corridor}}{\text{the full amount of the clawback corridor}} \right)$$

As previously mentioned, the corridor is \$50,000 for single individuals and \$100,000 for married individuals filing a joint return. This corridor begins at \$157,500 for a single individual and \$315,000 for married individuals filing a joint return.

The flowchart on the following page best describes the above:



Exception for Certain Specified Service Trades or Businesses



Q. 26: How does the limited benefit for S.S.T.B. work in an actual fact pattern?

The limited benefit for S.S.T.B is illustrated in the following example.

- Mrs. Z is the founding partner of P.L.L.C. Z, a law firm. Mrs. Z is the only partner and P.L.L.C. Z has two employees that are paid wages in an aggregate amount of \$50,000. P.L.L.C. Z has ordinary taxable income of \$400,000, and no machinery and other property is used in its business. Further, Mrs. Z has no qualified cooperative dividends, qualified R.E.I.T. dividends, qualified

“The I.R.S. will issue regulations or a notice that will provide official guidance.”

publicly traded partnership income, or net capital gain. Finally, Mr. Z, her husband, is unemployed.

- Mrs. Z’s threshold amount is \$315,000. Since she files a joint return with her spouse. Mrs. Z’ upper phase-in limit is \$415,000 (*i.e.*, \$315,000 + \$100,000).
- Because Mrs. Z’s income is greater than the threshold amount but not in excess of the phase-in limit, Mrs. Z is entitled to a limited deduction computed as follows:
 - Applicable Percentage: $100\% - 85\% = 15\%$
 - This calculation is based on the following factors:
 - Total income within the clawback corridor = \$85,000 (*i.e.*, \$400,000 - \$315,000)
 - Total amount of the corridor = \$100,000
 - Tentative Deduction: $15\% \times 20\%$ of the \$400,000 taxable income attributable to the S.S.T.B. = \$12,000
 - First Ceiling Amount: $15\% \times 50\%$ of the \$50,000 of W-2 wages = \$3,750
 - Second Ceiling Amount: $15\% \times 25\%$ of the \$50,000 of W-2 wages (\$1,875) + 2.5% of the unadjusted basis of property (\$0) = \$1,875
- Mrs. Z would have been entitled to a deduction of \$12,000 had the total taxable income on her tax return been under \$315,000. However, because her total taxable income exceeds the threshold but not the \$100,000 clawback corridor, her deduction is equal to \$3,750 under the first ceiling plus a portion of the \$8,250 difference between the \$12,000 Tentative Q.B.I. Deduction and the \$3,750 amount under the first ceiling (see Q. 24, Example 2).
- Mrs. Z’s total taxable income exceeds the threshold amount by \$85,000 (*i.e.*, \$400,000 - \$315,000). Applying the formula described above, the \$8,250 benefit for being under the threshold is multiplied by a fraction to determine the clawback:
 - $\$8,250 \times (\$85,000 \div \$100,000) = \$ 7,012.50$
 - The remainder of \$1,237.50 is added to \$3,750, and the Code §199A deduction under the phaseout is \$4,987.50.
- Mrs. Z would have been entitled to a deduction of \$33,250 had P.L.L.C. Z’s activity not been an S.S.T.B. As a result of her S.S.T.B., her deduction is limited to \$4,987.50. If Mrs. Z and her husband’s taxable income exceeds \$415,000, they would lose the benefit of the deduction, absent any qualified R.E.I.T. dividends, qualified publicly traded partnership interest, or qualified cooperative dividends.

CONCLUSION

At some point, the I.R.S. will issue regulations or a notice that will provide official guidance. Congress may also revisit the provision to rewrite in a more understandable way. In the interim, this article has attempted to provide structure to the unstructured approach of the statute, following a step-by-step method to explain the application of the Q.B.I. deduction. In so doing, it has focused on principles that apply to each element of the deduction.