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III. Deduction for Qualified Business Income of an Individual (Passthrough Break)

[Qualified Trade or Business](#)

["Domestic" Business Income Requirement](#)

[Qualified Business Income](#)

[Calculating the Deduction](#)

[W-2 Wage Limitation on the Deduction](#)

[W-2 Wages Defined](#)

[Qualified Property Defined](#)

[Phase-in of W-2 Wage Limitation](#)

[Carryover Losses](#)

[Treatment of Investment Income](#)

[Special Rules for Partnerships and S Corporations](#)

[Qualified REIT Dividends, Cooperative Dividends, and Publicly Traded Partnership Income](#)

[Determining the Final Amount of the Deduction for Qualified Business Income](#)

[Treatment of Trusts and Estates](#)

[Treatment of Agricultural and Horticultural Cooperatives](#)

III. Deduction for Qualified Business Income of an Individual (Passthrough Break)

Under TCJA, sole proprietors, partners in partnerships, members in LLCs taxed as partnerships (hereafter, "partners"), and shareholders in S corporations may qualify for a new deduction for qualified business income for tax 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.
Example: In 2018, Joe receives a salary of \$100,000 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 of \$50,000).

Observation: The effective marginal tax rate on qualified business income for individuals in the top 37-percent tax bracket who are able to fully apply the new deduction will be 29.6 percent - fully 10 points lower than the top rate under current law.

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.

Observation: The deduction is available to both nonitemizers and itemizers. The deduction for qualified business income is subject to several restrictions and limitations, discussed below.

Qualified Trade or Business

TCJA provides that qualified business income is determined for each qualified trade or business of the taxpayer. The term "qualified trade or business" means any trade or business other than: (1) a specified



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service trade or business (defined below); and (2) the trade or business of performing services as an employee.

Specified Service Trade or Business. A specified service trade or business means any trade or business involving the performance of services in the fields of health, law, consulting, athletics, financial services, brokerage services, or 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 or owners, or which involves the performance of services that consist of investing and investment management trading, or dealing in securities, partnership interests, or commodities. For this purpose, a security and a commodity have the meanings provided in the rules for the mark-to-market accounting method for dealers in securities (Code Sec. 475(c)(2) and Code Sec. 475(e)(2), respectively). 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).

The threshold amount is indexed for inflation. The exclusion from the definition of a qualified business for specified service trades or businesses is fully phased in for a taxpayer with taxable income in excess of the threshold amount plus \$50,000 (\$100,000 in the case of a joint return). For a taxpayer with taxable income within the phase-in range, the exclusion applies as follows.

Phase-in of Specified Service Business Limitation. In computing the qualified business income with respect to a specified service trade or business, the taxpayer takes into account only the applicable percentage of qualified items of income, gain, deduction, or loss, and of allocable W-2 wages. The applicable percentage with respect to any tax year is 100 percent reduced by the percentage equal to the ratio of the excess of the taxable income of the taxpayer over the threshold amount bears to \$50,000 (\$100,000 in the case of a joint return).

Example: Tom, an unmarried taxpayer, has taxable income of \$187,500, of which \$150,000 is attributable to an accounting sole proprietorship. Assume that the sole proprietorship's W-2 wages are high enough that the W-2 wage limitation (see below) will not affect Tom's deduction. Tom has an applicable percentage of 40 percent [$\$187,500 - \$157,500$ (Tom's threshold amount) = $\$30,000 / \$50,000$ (phaseout range) = 60 percent; 100 percent - 60 percent = 40 percent]. In determining includible qualified business income, Tom takes into account 40 percent of \$150,000, or \$60,000. Because we're assuming that the W-2 wage limitation doesn't apply, Tom's deduction for qualified business income is 20 percent of \$60,000, or \$12,000. ([return to Deduction for Qualified Business Income of an Individual](#))

"Domestic" Business Income Requirement

Items are treated as qualified items of income, gain, deduction, and loss only to the extent they are effectively connected with the conduct of a trade or business within the United States. In the case of a taxpayer who is an individual with otherwise qualified business income from sources within the commonwealth of Puerto Rico, if all the income is taxable under Code Sec. 1 (income tax rates for individuals) for the tax year, the "United States" is considered to include Puerto Rico for purposes of determining the individual's qualified business income. ([return to Deduction for Qualified Business Income of an Individual](#))

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.



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Similarly, qualified business income does not include any guaranteed payment for services rendered with respect to the trade or business, and to the extent provided in regulations, does not include any amount paid or incurred by a partnership to a partner who is acting other than in his or her capacity as a partner for services.

Example: Charlotte is a partner in, and sales manager for, the XYZ partnership, a domestic business that is not a specified service trade or business. During the tax year, she receives guaranteed payments of \$250,000 from XYZ for her services to the partnership as its sales manager. In addition, her distributive share of XYZ's ordinary income (it's only item of income or loss) was \$175,000. Charlotte's qualified business income from XYZ is \$175,000.

The determination of qualified items of income, gain, deduction, and loss takes into account these items only to the extent included or allowed in the determination of taxable income for the year.

Example: During the tax year, a qualified business has \$100,000 of ordinary income from inventory sales, and makes an expenditure of \$25,000 that is required to be capitalized and amortized over five years under applicable tax rules. Qualified business income is \$100,000 minus \$5,000 (current-year ordinary amortization deduction), or \$95,000. The qualified business income is not reduced by the entire amount of the capital expenditure, only by the amount deductible in determining tax income for the year. ([return to Deduction for Qualified Business Income of an Individual](#))

Calculating the Deduction

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 50 percent of the W-2 wages (defined below) with respect to the trade or business or 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.

The amount in "(2)" is referred to hereafter as "the W-2 wage limitation." ([return to Deduction for Qualified Business Income of an Individual](#))

W-2 Wage Limitation on the Deduction

The W-2 wage limitation on the deduction for qualified business income is based on either W-2 wages paid, or W-2 wages paid plus a capital element. This limitation is phased in above a threshold amount of taxable income (see below). Specifically, the limitation is the greater of: (1) 50 percent of the W-2 wages paid with respect to the qualified trade or business; or (2) the sum of 25 percent of the W-2 wages with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property.

Example: Susan owns and operates a sole proprietorship that sells cupcakes. The business is not a specified service business and Susan's filing status for Form 1040 is single. 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 Susan has no other items of income or loss (putting her taxable income at a level where she's fully subject to the W-2 wage limitation). 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 greater of (i) 50 percent of W-2 wages (\$50,000) or (ii) 25 percent of W-2 wages plus 2.5 percent of qualified property (\$25,000) (\$25,000 (\$100,000 x 25 percent) + \$0 (2.5 percent x \$0)).

Observation: The first of the two ways of calculating the W-2 wage limitation (50 percent of W-2 wages) is the one that will apply to most business that have employees. The second way (25 percent of W-2 wages plus 2.5 percent of qualified property) will mainly apply to real estate activities and other activities that have an unusually high ratio of qualifying property to employees. ([return to Deduction for Qualified Business Income of an Individual](#))



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W-2 Wages Defined

W-2 wages are the total wages subject to wage withholding, elective deferrals, and deferred compensation paid by the qualified trade or business with respect to employment of its employees during the calendar year ending during the tax year of the taxpayer. W-2 wages do not include any amount which is not properly allocable to the qualified business income as a qualified item of deduction. In addition, W-2 wages do not include any amount which was not properly included in a return filed with the Social Security Administration (SSA) on or before the 60th day after the due date (including extensions) for such return. ([return to Deduction for Qualified Business Income of an Individual](#))

Gray Area: The language of new Code Sec. 199A (which provides the rules for the deduction for qualified business income), appears to treat S corporation shareholders and partners in partnerships differently for the narrow purpose of calculating the W-2 wage limitation. Reasonable compensation paid to an S corporation shareholder as wages appear to fall within the definition of W-2 wages for purposes of applying the limitation. By contrast, guaranteed payments to a partner appear not to fall within the definition.

Caution: The text of Code Sec. 199A is convoluted, and other commentators and (and the IRS) may have a different interpretation of how the definition of W-2 wages applies to S corporation shareholders vs. partners and LLC members. Even if our interpretation holds up, there is no indication that Congress intended to treat these types of owners differently with respect to how W-2 wages are calculated. So, for now, practitioners may want to note this as a gray area, and one that will be ripe to be addressed in a future technical corrections bill.

In the case of a taxpayer who is an individual with otherwise qualified business income from sources within the commonwealth of Puerto Rico, if all the income is taxable under Code Sec. 1 (income tax rates for individuals) for the tax year, the determination of W-2 wages with respect to the taxpayer's trade or business conducted in Puerto Rico is made without regard to any exclusion under the wage withholding rules for remuneration paid for services in Puerto Rico. ([return to Deduction for Qualified Business Income of an Individual](#))

Qualified Property Defined

For purposes of this provision, qualified property means tangible property of a character subject to depreciation that is held by, and available for use in, the qualified trade or business at the close of the tax year, and which is used in the production of qualified business income, and for which the depreciable period has not ended before the close of the tax year. The depreciable period with respect to qualified property of a taxpayer means the period beginning on the date the property is first placed in service by the taxpayer and ending on the later of (1) the date 10 years after that date, or (2) the last day of the last full year in the applicable recovery period that would apply to the property under Code Sec. 168 (without regard to Code Sec. 168(g)).

Example: Walter (who is subject to the limitation on the deduction for qualified business income) does business as a sole proprietorship conducting a widget-making business. The business buys a widget-making machine for \$100,000 and places it in service in 2020. The business has no employees in 2020. The W-2 limitation in 2020 is the greater of (a) 50 percent of W-2 wages, or \$0, or (b) the sum of 25 percent of W-2 wages (\$0) plus 2.5 percent of the unadjusted basis of the machine immediately after its acquisition: $\$100,000 \times .025 = \$2,500$. The amount of the limitation on Walter's deduction is \$2,500. In the case of property that is sold, for example, the property is no longer available for use in the trade or business and is not taken into account in determining the limitation. TCJA provides that the IRS must provide rules for applying the limitation in cases of a short tax year in which the taxpayer acquires, or disposes of, the major portion of a trade or business or the major portion of a separate unit of a trade or business during the year. The IRS is required to provide guidance applying rules similar to the rules of Code Sec. 179(d)(2) to address acquisitions of property from a related party, as well as in a sale-leaseback or other transaction as needed to carry out the purposes of the provision and to provide anti-abuse rules, including under the limitation based on W-2 wages and capital. Similarly, the IRS must

provide guidance prescribing rules for determining the unadjusted basis immediately after acquisition of qualified property acquired in like-kind exchanges or involuntary conversions as needed to carry out the purposes of the provision and to provide anti-abuse rules, including under the limitation based on W-2 wages and capital. ([return to Deduction for Qualified Business Income of an Individual](#))

Phase-in of W-2 Wage Limitation

The application of the W-2 wage limitation phases in for a taxpayer with taxable income in excess of the following threshold amounts: \$315,000 for joint filers and \$157,500 for all other taxpayers, indexed for inflation. For purposes of phasing in the wage limit, taxable income is computed without regard to the 20 percent deduction.

The W-2 wage limitation applies fully for a taxpayer with taxable income in excess of the threshold amount plus \$50,000 (\$100,000 in the case of a joint return). For a taxpayer with taxable income within the phase-in range, the wage limit applies as follows. With respect to any qualified trade or business, the taxpayer compares -

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

(2) the W-2 wage limitation (see above) with respect to the qualified trade or business.

If the amount determined under (2) is less than the amount determined (1), (that is, if the wage limit is binding), the taxpayer's deductible amount is the amount determined under (1) reduced by the same proportion of the difference between the two amounts as the excess of the taxable income of the taxpayer over the threshold amount bears to \$50,000 (\$100,000 in the case of a joint return). ([return to Deduction for Qualified Business Income of an Individual](#))

Carryover Losses

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. Similar to a qualified trade or business that has a qualified business loss for the current tax year, any deduction allowed in a subsequent year is reduced (but not below zero) by 20 percent of any carryover qualified business loss.

Example: Sean has qualified business income of \$20,000 from qualified business A and a qualified business loss of \$50,000 from qualified business B in Year 1. Sean is not permitted a deduction for Year 1 and has a carryover qualified business loss of \$30,000 to Year 2. In Year 2, Sean has qualified business income of \$20,000 from qualified business A and qualified business income of \$50,000 from qualified business B. To determine the deduction for Year 2, Sean reduces the 20 percent deductible amount determined for the qualified business income of \$70,000 from qualified businesses A and B by 20 percent of the \$30,000 carryover qualified business loss. ([return to Deduction for Qualified Business Income of an Individual](#))

Treatment of Investment Income

Qualified items of income, gain, deduction, and loss do not include specified investment-related income, deductions, or loss. Specifically, qualified items of income, gain, deduction and loss do not include (1) any item taken into account in determining net long-term capital gain or net long-term capital loss, (2) dividends, income equivalent to a dividend, or payments in lieu of dividends, (3) interest income other than that which is properly allocable to a trade or business, (4) the excess of gain over loss from commodities transactions, other than those entered into in the normal course of the trade or business or with respect to stock in trade or property held primarily for sale to customers in the ordinary course of the trade or business, property used in the trade or business, or supplies regularly used or consumed in the trade or business, (5) the excess of foreign currency gains over foreign currency losses from Code Sec. 988 transactions, other than transactions directly related to the business needs of the business activity, (6) net income from notional principal contracts, other than clearly identified hedging transactions that are treated as ordinary (i.e., not treated as capital assets), and (7) any amount received from an annuity that is not used in the trade or business of the business activity. Qualified items under this provision do not



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include any item of deduction or loss properly allocable to such income. ([return to Deduction for Qualified Business Income of an Individual](#))

Special Rules for Partnerships and S Corporations

TCJA provides that, in the case of a partnership or S corporation, the business income deduction applies at the partner or shareholder level. Each partner 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 tax year equal to the partner's allocable share of W-2 wages of the partnership. The partner's allocable share of W-2 wages is required to be determined in the same manner as the partner's share of wage expenses.

For example, if a partner is allocated a deductible amount of 10 percent of wages paid by the partnership to employees for the tax year, the partner is required to be allocated 10 percent of the W-2 wages of the partnership for purposes of calculating the wage limit under this deduction. Similarly, each shareholder of an S corporation takes into account the shareholder's pro rata share of each qualified item of income, gain, deduction, and loss, and is treated as having W-2 wages for the tax year equal to the shareholder's pro rata share of W-2 wages of the S corporation. ([return to Deduction for Qualified Business Income of an Individual](#))

Qualified REIT Dividends, Cooperative Dividends, and Publicly Traded Partnership Income

A deduction is allowed under the provision for 20 percent of the taxpayer's aggregate amount of qualified REIT dividends, qualified cooperative dividends, and qualified publicly traded partnership income for the tax year. Qualified REIT dividends do not include any portion of a dividend received from a REIT that is a capital gain dividend or a qualified dividend. A qualified cooperative dividend means a patronage dividend, per-unit retain allocation, qualified written notice of allocation, or any similar amount, provided it is includible in gross income and is received from either (1) a tax-exempt benevolent life insurance association, mutual ditch or irrigation company, cooperative telephone company, like cooperative organization, or a taxable or tax-exempt cooperative that is described in Code Sec. 1381(a), or (2) a taxable cooperative governed by tax rules applicable to cooperatives before the enactment of subchapter T of the Code in 1962. Qualified publicly traded partnership income means (with respect to any qualified trade or business of the taxpayer), the sum of the (1) the net amount of the taxpayer's allocable share of each qualified item of income, gain, deduction, and loss (that are effectively connected with a U.S. trade or business and are included or allowed in determining taxable income for the tax year and do not constitute excepted enumerated investment-type income, and not including the taxpayer's reasonable compensation, guaranteed payments for services, or (to the extent provided in regulations) Code Sec. 707(a) payments for services) from a publicly traded partnership not treated as a corporation, and (2) gain recognized by the taxpayer on disposition of its interest in the partnership that is treated as ordinary income (for example, by reason of Code Sec. 751). ([return to Deduction for Qualified Business Income of an Individual](#))

Determining the Final Amount of the Deduction for Qualified Business Income

An individual taxpayer generally may deduct an amount equal to the sum of -
(1) the lesser of (a) the combined qualified business income amount for the tax year; or (b) an amount equal to 20 percent of the excess (if any) of taxpayer's taxable income for the tax year over the sum of any net capital gain and qualified cooperative dividends, plus
(2) the lesser of 20 percent of qualified cooperative dividends for the tax year or taxable income (reduced by net capital gain).

This sum may not exceed the taxpayer's taxable income for the tax year (reduced by net capital gain). ([return to Deduction for Qualified Business Income of an Individual](#))

Treatment of Trusts and Estates

TCJA provides that trusts and estates are eligible for the 20-percent deduction. Rules similar to the rules under present-law Code Sec. 199 (as in effect on December 1, 2017) apply for apportioning between fiduciaries and beneficiaries any W-2 wages and unadjusted basis of qualified property under the



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limitation based on W-2 wages and capital. ([return to Deduction for Qualified Business Income of an Individual](#))

Treatment of Agricultural and Horticultural Cooperatives

For tax years beginning after December 31, 2017, but not after December 31, 2025, a deduction is allowed to any specified agricultural or horticultural cooperative equal to the lesser of (1) 20 percent of the cooperative's taxable income for the tax year or (2) the greater of 50 percent of the W-2 wages paid by the cooperative with respect to its trade or business or the sum of 25 percent of the W-2 wages of the cooperative with respect to its trade or business plus 2.5 percent of the unadjusted basis immediately after acquisition of qualified property of the cooperative. A specified agricultural or horticultural cooperative is an organization to which subchapter T applies that is engaged in (1) the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product, (2) the marketing of agricultural or horticultural products that its patrons have so manufactured, produced, grown, or extracted, or (3) the provision of supplies, equipment, or services to farmers or organizations described in the foregoing.

Effective Date

The provision is effective for tax years beginning after December 31, 2017, and does not apply to tax years beginning after December 31, 2025. ([return to Deduction for Qualified Business Income of an Individual](#))