

Tax Cuts and Jobs Act (TCJA) – Deduction for Qualified Business Income

Quick Reference

Note: The deduction for qualified business income (a.k.a., “the passthrough break”) is effective for tax years beginning after December 31, 2017 and ending before January 1, 2026.

Description of the Deduction

Item	TCJA Provision
Description	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. The amount of the deduction is generally 20 percent of the taxpayer’s qualifying business income.
Claiming the Deduction	The deduction for qualified business income is claimed by individual taxpayers on their personal tax returns. The deduction reduces taxable income, and is available to both nonitemizers and itemizers. The deduction is not used in computing adjusted gross income, so it does not affect limitations based on adjusted gross income.
Basic Example	<i>Example:</i> 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). Joe can be claim the deduction on his 2018 Form 1040 as a reduction to taxable income.

Qualified Trade or Business

Item	TCJA Provision
Qualified Trade or Business Defined	<p>A qualified trade or business means any trade or business other than –</p> <ul style="list-style-type: none"> • a specified service trade or business; or • the trade or business of being an employee. <p>The rule disqualifying specified service trade or businesses (defined below) does not apply to taxpayers with taxable income below certain thresholds. The rule disqualifying employees, by contrast, is absolute – it applies to all employees regardless of the amount of their taxable income.</p>
Specified Service Trade or Business	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.

Qualified Business Income

Item	TCJA Provision
Qualified Business Income (QBI) Defined	<p>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. QBI 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.</p> <p>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.</p>
"Domestic" 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.
Investment-Related Items Excluded	Qualified items of income, gain, deduction, and loss 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).

Calculating the Deduction

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Calculating the Deduction	<p>The deductible amount for each qualified trade or business is the lesser of –</p> <p>(1) 20 percent of the taxpayer's QBI with respect to the trade or business; or</p> <p>(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.</p> <p>The amount in "(2)" is referred to hereafter as "the W-2 wage limitation."</p>

W-2 Wage Limitation on the Deduction

Item	TCJA Provision
W-2 Wage Limitation Explained	<p>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.</p> <p>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</p>

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	<p>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)).</p> <p>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.</p>
Phase-in of W-2 Wage Limitation	<p>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).</p>
W-2 Wages Defined	<p>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.</p> <p>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.</p>
Qualified Property Defined	<p>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 –</p> <ul style="list-style-type: none"> • the date 10 years after that date; or • 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)). <p>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 x .025 = \$2,500. The amount of the limitation on Walter's deduction is \$2,500.</p> <p>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.</p>

Determining the Final Amount of the Deduction

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Determining the Final Amount of the Deduction	<p>An individual taxpayer generally may deduct an amount equal to the sum of –</p> <ol style="list-style-type: none"> (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).

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	This sum may not exceed the taxpayer's taxable income for the tax year (reduced by net capital gain).

Additional Rules

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Special Rules for Partnerships and S Corporations	<ul style="list-style-type: none"> 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. Similar rules apply to S corporation shareholders. Each shareholder 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.
Treatment of Trusts and Estates	<p>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 limitation based on W-2 wages and capital.</p>
Treatment of Agricultural and Horticultural Cooperatives	<ul style="list-style-type: none"> 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.
Qualified REIT Dividends, Cooperative Dividends, and Publicly Traded Partnership Income	<ul style="list-style-type: none"> A deduction is allowed 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. Qualified cooperative dividends refers to patronage dividends, per-unit retain allocations, qualified written notices 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)

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	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).

Related Materials on TCJA

- Parker's in-depth explanation of TCJA – Parker's Federal Tax Bulletin, Issue 160 (December 26, 2017)
- Sample client letter explaining TCJA's provisions affecting individuals – Parker Tax ¶ 320,125.
- Sample client letter explaining TCJA's provisions affecting businesses – Parker Tax ¶ 320,124.
- Quick reference guide – TCJA Provisions Affecting Individuals – Parker Tax ¶ 360,005.
- Quick reference guide – TCJA Provisions Affecting Businesses – Parker Tax ¶ 360,006.
- Quick reference guide – Comparison of the House, Senate, and Conference Committee Bills – Parker Tax ¶ 360,140.
- Legislative text of the Tax Cuts and Jobs Acts of 2017 (Pub. L. 115-97) – Parker's Federal Tax Legislation database.