

Deduction for Qualified Business Income of Pass-Thru Entities

By Kent L. Schwarz

One of the most important provisions of the new tax law is the deduction for qualified business income of pass-thru entities under new Code Section 199A. While the provision is complicated and some details will need to be flushed out through regulations, administrative guidance and case law, a high level summary is as follows:

- Owners of pass-thru entities can deduct twenty (20%) of so-called “qualified business income” (“QBI”) subject to certain limits.
- The deduction is below the line (does not reduce AGI), but permitted whether or not a taxpayer itemizes.
- There is a deduction limit based upon the level of W-2 wages being paid by the business which is the greater of (i) 50% of the taxpayer’s share of the W-2 wages of the qualifying business or (ii) 25% of such wages plus 2.5% of the unadjusted basis of depreciable tangible property held by the qualified business and used in the production of QBI.

QBI from certain “specified service trades or businesses” (“SSTB”) is not eligible for the deduction, unless the taxpayer’s taxable income (before the 20% deduction) is under certain limits. An SSTB is (i) any business described in Code Section 1202(e)(3)(A) (without regard to the words engineering or architecture) or (ii) which involves the services of investing, investment management, trading, or dealing in securities, partnership interests, or commodities. Code Section 1202(e)(3)(A) enumerates a laundry list of services consisting of:

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| ▪ Health | ▪ Athletics |
| ▪ Law | ▪ Financial services |
| ▪ Accounting | ▪ Brokerage services, or |
| ▪ Actuarial services | ▪ Any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners. |
| ▪ Performing arts | |
| ▪ Consulting | |



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There is very little law clarifying the meaning of the listed items or the catch-all in Section 1202(e)(3)(A), leaving this fertile ground for dispute.

Even if a taxpayer has QBI from an SSTB, they can still qualify for the 20% deduction if their taxable income (computed without regard to the deduction for QBI) is under a threshold of \$157,500 (single) or \$315,000 (married joint). The full deduction is phased out over the next \$50,000 and \$100,000 of taxable income, respectively. Moreover, the W-2 wage limit described above does not apply for taxpayers under this threshold (subject to the same phase out range).

QBI does not include reasonable compensation paid to the taxpayer by the qualified business or guaranteed payments paid to a partner for services rendered in connection with the business. There has always been a requirement that S-corporations pay reasonable compensation to its owners to backstop the payroll tax. See, e.g., Spicer Accounting, Inc. v. United States, 918 F.2d 90 (9th Cir. 1990). The same requirement does not currently apply to partners in partnerships. Although one might expect this perceived loophole to be closed in a similar manner as currently applies to S-corporation shareholders.

Accordingly, there may be planning opportunities in structuring compensation arrangements to maximize the deduction for owners of pass-thru entities.

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