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Advisers Longing Clarity on Qualified Business Income Deduction

PROFESSIONAL SERVICES, TAX, TAX REFORM
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When the Tax Cuts and Jobs Act (The Act) was signed into law at the end of 2017, questions arose immediately regarding the applicability of the 20% deduction for Qualified Business Income (QBI). It was immediately clear that the deduction would not provide the same tax relief for the professional service industry as it does for many other industry groups. Seven months later, upcoming guidance is desperately necessary to provide professional service taxpayers with the information to deploy proper planning and organization strategies prior to the end of the year.

How the deduction works?

The deduction, at first glance, appears simple: a 20% deduction of Qualified Business Income (QBI) earned in a “qualified trade or business” is available for business owners organized as sole proprietorships or pass-through entities. However, the deduction must pass through two additional limitations if the taxpayer’s taxable income is greater than \$157,500 for the year (\$315,000 for married filing jointly). First, the deduction is limited to the greater of 50% of W-2 wages or 25% of W-2 wages plus 2.5% of the unadjusted basis cost of tangible property immediately after acquisition of qualified property. Finally, the resulting deduction is limited to 20% of the excess of taxable income over the sum of capital gains plus qualified cooperative dividends.

The purpose of the deduction is to keep entities subject to a single layer of tax competitive with their double-taxed C-Corporation counterparts that received a tax cut to a 21% flat tax. Taxpayers who are eligible to receive the maximum 20% deduction will be taxed at a maximum of 29.6% on QBI.

Specified Services

For those in the professional service industry, their trade or business may not qualify for the QBI deduction. The Act refers to specified service trade or businesses as those involved in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business if such trade or business is based on the reputation or skill of one or more of its employees or owners.

It is important to note that the same exception for taxable income applies to the specified service rule. Therefore, if the business owner’s taxable income is less than \$157,500 for the year (\$315,000 for married filing jointly), he/she may still claim the QBI deduction assuming he/she meets other qualifying factors.

The hope is that the anticipated regulations will provide answers for single businesses with multiple separate trades or businesses. If an entity combines specified service businesses with a qualified trade or business, it is unclear whether a deduction is available for the qualified portion of the entity. If the deduction denied, it is likely advantageous to separate the businesses into separate entities. In addition, more clarity is required regarding service-related businesses that may fall outside the specified service definition, which is currently very vague and broad.

Guaranteed Payments

Guaranteed payments to partners are common in professional services companies organized as a partnership. These payments are made to a partner for services rendered with respect to a trade or business. These payments are explicitly excluded from QBI. To this point, a consideration is to review partnership agreements for possible revisions to distribute income in a different fashion. In addition, guaranteed payments are not included as wages for the 50% or 25% wage limit test. Therefore, additional consideration should be given to entity structure.

When will we have answers?

As covered in prior *Our Thoughts On* articles, the American Institute of Certified Public Accountants (AICPA) requested additional guidance in the form of a letter to the Internal Revenue Service (IRS) at the end of February. The AICPA subsequently listed the request on its "Recommendations for 2018-2019 Guidance Priority List" letter dated June 14, 2018. It is not clear when the guidance will be available, but it is clearly one of the most anticipated regulation sections for tax advisers as 2018 progresses.

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