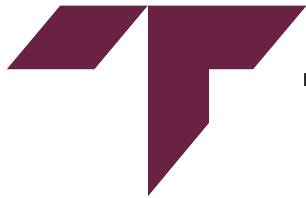

Trust Company Oklahoma

INVESTMENT PERSPECTIVES

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Playing Hoops With the IRS

I am a self-proclaimed tax nerd. I've been told that not everyone loves taxes as much as me, but I find that hard to believe. I mean, who doesn't love digging through tax code to put the puzzle pieces together? However, even I have to admit that the IRS seems to find joy in making some tax laws overly complicated, and one that falls squarely into this category is the new Qualified Business Income (QBI) deduction, also referred to as the Section 199A deduction. Let's review this deduction to see where you fit within the QBI rules.

The QBI deduction was part of the 2018 Tax Cuts and Jobs Act (TCJA) and applies to Qualified Business Income from pass-thru entities. These entities do not pay taxes at the business level but instead "pass-thru" the income to their owners. Pass-thru entities include sole-proprietorships, LLCs, partnerships, and S-corporations.

Even if you don't have a pass-thru entity, you could still be affected because QBI also includes real estate investment trusts (REITs) and publically traded partnerships (PTPs), including master limited partnerships (MLPs).

Understanding QBI Deduction

The QBI deduction is a 20% reduction of your taxable income received from the pass-thru entity. If you are in the highest tax bracket at 37%, this deduction lowers your effective tax rate on Qualified Business Income to just 29.6%. However, the IRS makes you jump through various hoops to obtain the deduction.

The **first hoop** is an income threshold. If your taxable income is below a certain limit (for 2019: $321,400 Married Filing Jointly or $160,700 Filing

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Single), you've earned your 20% deduction – congratulations! Once your taxable income is above these levels, you fall into a phase-out range, meaning you may receive only a partial deduction.

However, if you are above $421,400 Married Filing Jointly or $210,700 Filing Single, you must jump through a **second hoop**: your business category. If your business falls into the dreaded "Specified Service Trade or Business" (SSTB) category, your deduction is $0. The SSTB category includes the following: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial/brokerage/investing, or businesses which rely on the reputation or skill of its employees or owners.

If your business is not a SSTB, but your taxable income is above the threshold, you must go through a **third hoop**. Your potential 20% QBI deduction is now limited to the greater of 50% of your share of W-2 wages paid by your business or 25% of your share of wages + 2.5% of the unadjusted basis of qualified property. I know that sounds like a poorly written SAT question, but let me explain the reasoning behind this.

The TCJA's goal was to stimulate economic growth so they created the QBI to reward businesses that are employing others and/or putting their money to work via capital investments. As long as you are doing one of these two things, you can receive your deduction, hence the "greater-of" test for wages or capital investment.

It is important to note that income from REITs and PTPs are not subject to any of the above hoops. These automatically qualify for the 20% QBI deduction. In fact, there is a new box entitled Section 199A Dividends on 1099-DIV forms to identify dividends that qualify for this deduction.

Now for the **final hoop**. Once you've calculated your individual QBI deductions, you combine them to arrive at your overall QBI deduction. This is limited to 20% of your taxable income, not including capital gains.

Due to the many nuances surrounding the QBI calculations, rest assured, CPAs will be earning their fees this year. Here's to its many hoops and hoping you were able to pass through them!