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Congress Passes Tax Cuts and Jobs Act

Understanding the New "Qualified Business Income Deduction"

The Tax Cuts and Jobs Act of 2017 made significant changes to the Internal Revenue Code effective for tax years beginning after December 31, 2017. Among the changes is a new deduction for income from businesses operated as flow through entities. The deduction, often referred to as the **Qualified Business Income Deduction** (the "QBI Deduction"), is codified as Section 199A of the Code. This Tax Reform Update discusses the QBI Deduction and how it may affect your business. As always, please contact any member of Bodman's Tax Practice Group listed on page 4 for more information.

How it Works

Potential 20% QBI Deduction: For taxpayers who receive business income from partnerships, S Corporations and sole proprietorships, there is potentially a QBI Deduction as high as 20% on Qualified Business Income.

Observation: Qualified Business Income ("QBI") generally means net income from ordinary business operations and does not include certain passive income (capital gains, interest, dividends and other non-business activity). QBI does not include wages and guaranteed payments that a taxpayer receives from the business.

The actual QBI Deduction allowed can range from 0% to 20% depending on various factors, including the taxpayer's taxable income, W-2 wages paid by the business, the cost of certain assets purchased by the business, and the type of business the entity conducts.

The analysis for calculating the actual QBI Deduction is discussed below. Please also see Chart A, 199A Mechanical Flow Chart on page 3, for a simple view of how the potential 20% QBI Deduction and its limitations might apply to you.

Actual QBI Deduction—Taxable Income in the Safe Zone: There is a safe zone where the 20% QBI Deduction is free of limitations for any taxpayer whose taxable income is below certain amounts ($157,500 if single and $315,000 if married filing joint). Taxpayers in that safe zone are entitled to a 20% QBI Deduction without any of the limitations discussed below.

Actual QBI Deduction—Taxable Income in the Restricted Zone: Taxpayers whose taxable income is above a certain amount ($207,500 if single and $415,000 if married) are subject to both of the limitations stated below.

Observation: The limitations below are phased in for a range of income between the Safe Zone and the Restricted Zone, but when taxable income reaches the Restricted Zone, the limitations below apply fully.

Limitation #1—Professional Services Businesses: Taxpayers in the Restricted Zone will not be entitled to take any QBI Deduction on income from a professional services business (such as accounting, law, health, etc.).

Observation: This is consistent with other provisions of the tax code that generally don't provide certain tax benefits to service companies.

Limitation #2—W-2 Wages and Business Assets: Taxpayers with pass through income from businesses other than professional services businesses will be eligible for a potential QBI Deduction up to 20%. The actual QBI Deduction, however, will be limited to the LESSER of:

- 20% of Qualified Business Income, or
- the GREATER of:
    - 50% of W-2 wages paid by the business, or
    - 25% of W-2 wages paid by the business plus 2.5 % of the unadjusted cost basis of certain business assets (the "Asset Base").

Observations: It appears that Congress placed these limitations for taxpayers with income in the Restricted Zone to encourage high income businesses to employ more workers (increase W-2 wages paid) or make capital expenditures (increase Asset Base), spurring economic growth, in order to maximize the QBI Deduction allowed.

The first limitation (50% of W-2 wages) benefits taxpayers with income from large manufacturers, retailers, or other businesses that pay high amounts of W-2 wages to employees. The potential 20% QBI Deduction is less likely to be limited for these types of taxpayers.

The second limitation (25% of W-2 wages plus 2.5% of Asset Base) benefits taxpayers with income from more capital intensive businesses (i.e. real estate) where not much, if any, is paid to W-2 employees. The incentive here is that capital intensive businesses, which support the economy through capital investment, will benefit from having an Asset Base that will help maximize the potential 20% QBI Deduction, since the W-2 wages be insufficient.

Examples

Chart B, the QBI Deduction Chart on page 4, includes some examples of how the QBI Deduction applies to taxpayers with income from various business types including retail, manufacturing, real estate, and professional services.

Entity Selection

The new QBI Deduction, along with the changes to the corporate and individual tax rates, may have an impact on the type of legal entity in which a taxpayer will want to operate their business. Please note that there are also numerous non-tax considerations that must be taken into account when choosing the right type of legal entity for your business. The Bodman tax group can help coordinate a review to determine what is best for your business.

What Now?

Because of the potential impact of the QBI deduction, it is important to consult with your Bodman attorney and your accountant to review your business structure and operations to ensure that you are maximizing tax efficiencies. Please call any member of the Bodman Tax Practice Group listed on page 4 to help you understand the impact of this new provision as well as the other changes to the tax code that may impact your business.

CHART A

199A - QUALIFIED BUSINESS INCOME DEDUCTION
MECHANICAL FLOW CHART

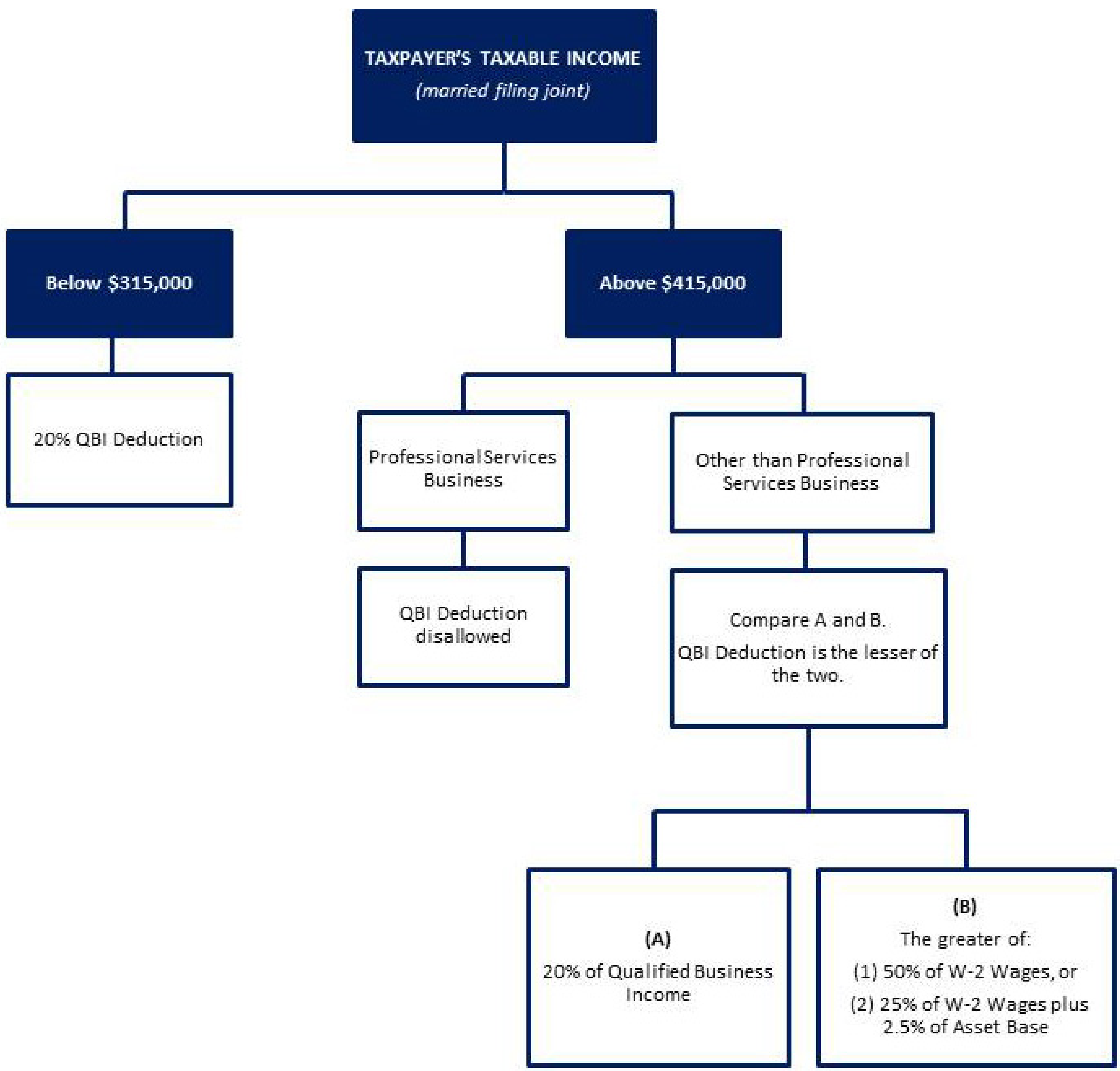

CHART B

QBI DEDUCTION						
Business	**Sole Proprietor (Retail)**		**Manufacturing**	**Real Estate**	**Professional Services**	
Qualified Business Income	$ 250,000	$ 500,000	$ 1,000,000	$ 1,000,000	$ 250,000	$ 1,000,000
Potential 20% Deduction	$ (50,000)	$ (100,000)	$ (200,000)	$ (200,000)	$ (50,000)	$ -
W-2 Wages	$ -	$ -	$ 150,000	$ -	$ -	$ 500,000
Asset Base	$ -	$ -	$ -	$ 10,000,000	$ -	$ -
Potential Caps on Deduction						
50% of W-2 Wages	$ -	$ -	$ (75,000)	$ -	0	$ (250,000)
25% of W-2 Wages + 2.5% of Asset Base	$ -	$ -	$ (37,500)	$ (250,000)	0	$ (125,000)
Actual Deduction Allowed	$ (50,000)	$ -	$ (75,000)	$ (200,000)	$ (50,000)	$ -
Taxable Income	$ 200,000	$ 500,000	$ 925,000	$ 800,000	$ 200,000	$ 1,000,000

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