

CLIENT ALERT

Construction Business Owners Can Benefit from the Qualified Business Income Deduction

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The Tax Cuts and Jobs Act of 2017 created a lucrative new tax incentive for certain business owners: the ability to deduct up to 20% of their qualified business income. Thus, a business owner who qualified for the deduction could earn a taxable income of \$500,000 but pay tax on as little as \$400,000, resulting in tax savings of nearly \$40,000.

Like nearly all provisions of the tax code, however, the deduction is subject to a myriad of exceptions, limitations, and special rules. Among other things, the deduction is reduced or even eliminated depending on the owner's income, the nature of the business, how the business is organized (the deduction is only available to pass-through businesses such as partnerships, S corporations, and sole proprietorships), how much the business pays in wages, and how much property it uses.

When the deduction was added to the tax code, construction business owners, in particular, faced uncertainty about whether they qualified for the deduction if their income exceeded a specified amount, whether they could combine multiple trades or businesses into a single business (or separate a single business into multiple businesses), and whether income from rental activities qualified for the deduction. Recent IRS regulations have clarified these and other issues, generally in taxpayer-friendly ways.

One of the major barriers to claiming the deduction is that the tax benefit phases out for individuals whose taxable income exceeds certain amounts (approximately \$320,000 for married people and \$160,000 for single individuals in 2019, indexed annually for inflation) and are engaged in a "specified service trade or business." A specified service trade or business includes any trade or business that involves the performance of services in the fields of law, medicine, accounting, and investment management, among others, but specifically excludes engineering and architecture. That was a welcome omission for owners of architectural and engineering firms since those fields are sometimes grouped with other professions for tax purposes.

A specified service trade or business also includes "consulting" and "any trade or business where the principal asset of such trade or business is the reputation or skill of one or more... employees or owners." That language led some construction business owners to question whether their activities could be described as consulting, or whether the deduction might be limited if their business was too dependent on the name recognition, reputation, or skill of certain owners or employees. Fortunately, the IRS answered both questions in the negative.

Recent regulations explain that consulting services "embedded in, or ancillary to," the sale of other goods or services will not cause a business to be a specified service trade or business. Thus, a construction company that provides incidental consulting services will not be a specified service business. Similarly, regulations clarify that a business, the principal asset of which is the reputation or skill of one or more employees or owners, means a business involving endorsement fees, licensing fees, or appearance fees. Thus, construction

businesses will not be specified service businesses even if they are named for one or more owners or employees or dependent on one or more owners' or employees' reputations.

Another issue addressed in the regulations is how to treat companies that engage in multiple trades or businesses, such as a construction firm involved in the development, leasing, and sales, or a builder engaged in different projects in multiple states. This is an important issue because the deduction is sometimes limited based on the amount of wages a business pays and the amount of property it uses and being able to combine wages and property from different lines of business generally is advantageous. The regulations generally allow a firm to aggregate wages and property used across multiple businesses, provided the businesses are commonly owned and are integrated from a business perspective. On the other hand, the IRS will not permit businesses to artificially increase the deduction by separating into multiple interrelated companies. For example, a law firm cannot avoid being a specified service business by creating a separate company to lease real estate or provide administrative services to the firm.

Finally, in a helpful clarification for businesses engaged in rental or leasing activity, the regulations provide that a rental real estate activity – which might not otherwise qualify as a trade or business – will be treated as a trade or business eligible for the 20% deduction, so long as at least 250 hours of rental services are performed each year and the business maintains separate and contemporaneous books and records. These rules exclude triple-net leases and residential leases.

The recent regulations represent a taxpayer-friendly interpretation of the qualified business income deduction and should allow many construction business owners to benefit from the deduction. As with most areas of tax law, however, the devil is in the details. To ensure that a business and its owners can benefit from the deduction to the greatest extent possible, it is advisable to consult a tax professional.



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