5 Key Strategies to Optimize the 20% §199A Deduction for Business Owners

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Tax Reform = Tax Breaks for All Businesses

C-corporations: Federal tax rate for 1.6M C-corps permanently reduced 40% (from 35% to 21%)

- 10 year "cost" to U.S.Treasury $1.4T

All other businesses: Temporary (2018-2025) 20% tax deduction for 35.3M owners of profitable "pass-through" entities (§199A)

- Sole Proprietors (1040 Schedule C)
- Partners (1065 K-1)
- S-Corp shareholders (1120S K-1)
- Owners of LLCs taxed as any of these 3
- 10 year "cost" to U.S.Treasury $415B

§199A Deduction

New Internal Revenue Code §199A creates:

- an income tax **deduction**
- taken on the **personal tax return** (Form 1040*)
- of an **owner** of a **pass-through entity**
- equal to **20%** of the **Qualified Business Income (QBI)** passing through

Deduction is taken:

- After all other items of income and deduction
- After standard or itemized deductions
- Last adjustment before applying tax rate tables

* Form 1041 in the case of an Estate or Trust

Effect of 20% Deduction

- Makes 20% of QBI tax-free
  - Federal only, no state income tax savings
- Reduces effective tax rate on the QBI by 20%
  - Compare to 40% reduction in C-corp tax rate

3 Limitations on the 20% Deduction

1. Can't exceed 20% of taxable income

2. If taxable income "too high" will be subject to a wage & property limitation on the deduction

3. If taxable income "too high" AND in a "specified service trade or business" §199A deduction is lost entirely

Limitation #1: 20% of Taxable Income

§199A deduction is lesser of:

- **20%** of the Qualified Business Income (QBI)* "passing through" to the owner; or
- **20%** of owner's taxable income**

*** QBI does not include investment income**
**** Taxable income excludes net capital gains**

Limitation #1 Example

Unmarried sole proprietor (any type of business)

- $100,000 Qualified Business Income
- No other income (interest, dividends, wages, etc.)*
- No deductions other than $12,000 standard deduction
- Taxable income before §199A deduction = $88,000

§199A deduction is lesser of:

- 20% x $100,000 QBI = $20,000 or
- 20% x $88,000 taxable income = **$17,600**

* Capital gains would not be included in computation of taxable income

Limitations #2 & #3 Phase-In When Taxable Income Exceeds "Threshold Amount"

- "Lower to moderate" income business owners (any type business) only have to deal with Limitation #1
- But "high income" business owners (taxable income above a "threshold amount") also have to deal with limitations #2 & #3

2018 Taxable Income Threshold Amounts for Limitations #2 & #3

$315,000 married filing jointly

$157,500 all other filers:

- Single
- Married filing separately
- Trust
- Estate

*Threshold amounts will be adjusted for COLA in future years

Limitations #2 & #3 Phase-In Range

- Limitations #2 and #3 "phase-in" as taxable income exceeds "threshold amounts":
  - Married Filing Jointly phase-in over next $100,000 (between $315,000 and $415,000)
  - All others phase-in over next $50,000 (between $157,500 and $207,500)

Limitation #2: Wage & Property Limitation

When taxable income exceeds full phase-in level ($207,500 or $415,000) deduction becomes the lesser of 3 amounts:

1. 20% of QBI
2. 20% of taxable income; or
3. Greater of:
   – 50% of wages paid to employees*; or
   – 25% of wages + 2.5% of cost basis in depreciable business property

*Includes wages paid to owners

Limitation #2 Purpose

Eliminates the §199A deduction for "high income" business owners that aren't "worthy" of the deduction because not contributing to economic growth by:

– Employing people; or
– Investing in business property

Limitation #3: Specified Service Limitation

If the business generating the income falls within the definition of a "Specified Service Trade or Business" (SSTB) and <u>taxable income</u> of the business owner exceeds the full phase-in level ($207,500 or $415,000) the §199A deduction is completely eliminated (zero, zip, nada)

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Limitation #3 Purpose

Eliminates the §199A deduction for "rich" professionals and certain other specified service business owners that make "too much" $$

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Specified Service Trades or Businesses

Law
Health
Accounting
Performing Arts
Consulting (?)
Athletics
Financial Services
Actuarial Services

Brokerage Services
(but not real estate or insurance)

Any other "where principal asset is reputation or skill of owner" (limited by regs)

But NOT architects, engineers or W-2 employees

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SSTB Maximum §199A Deduction

- SSTB maximum §199A deduction occurs:
  - When QBI is <u>at least</u> the threshold amount; and
  - Taxable income is <u>exactly</u> the threshold amount
- Married Filing Joint maximum deduction = **<u>$63,000</u>** (20% x $315,000), saves $15,120 in Federal tax
- All Others maximum deduction = **<u>$31,500</u>** (20% x $157,500), saves $7,560 in Federal tax

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Maximum Deduction Example - MFJ

Sally is a SSTB (doctor/lawyer/CPA, etc.) and files a joint return with spouse

QBI from practice	$ 315,000+	
Joint taxable income	$ 315,000	
Income tax under new rates before §199A		$64,179
§199A deduction (20% x $315,000)	$ 63,000	
Final taxable income after §199A	$ 252,000	
Income tax after §199A deduction		$49,059
Federal Tax savings (24% rate bracket x $63,000)		$**15,120**

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Maximum Deduction Example - Single

Joan is a SSTB (doctor/lawyer/CPA, etc.) and files as single or married filing separately

QBI from practice	$ 157,500+	
Joint taxable income	$ 157,500	
Income tax under new rates before §199A		$ 31,137
§199A deduction (20% x $157,500)	$ 31,500	
Final taxable income after §199A	$ 126,000	
Income tax after §199A deduction		$ 23,577
Federal Tax savings (24% rate bracket x $31,500)		**$ 7,560**

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§199A Summary Table

Taxable Income	20% QBI or 20% Taxable Income Deduction Rule Applies	Wage & Property Limit Applies	Specified Service Business Limit Applies
<$157,500 S < $315,000 J	Yes	No	No
$157,501- $207,500 S $315,501- $415,000 J	Yes	Wage/property limit phases-in	And §199A deduction phases-out
>$207,500 S >$415,000 J	Yes	Wage/property limit applies in full	No §199A deduction

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Strategy #1: Reduce Taxable Income with "Super Contribution" to Retirement Plan

Scenario: SSTB has too much taxable income

Example: Attorney Kathy files jointly with spouse:

- $415,000+ pass-through income from law practice
- Joint taxable income $415,000
- Kathy is in a "specified service business" and her taxable income is at the full phase-out level
- §199A deduction = $-0-
- Federal income tax = $96,629

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Strategy #1: Reduce Taxable Income with “Super Contribution”

Strategy #1: Kathy makes a $100,000 “Super Contribution” to a retirement plan

– After additional $100,000 deduction taxable income is reduced to optimum $315,000

– §199A deduction increased from zero to $63,000

$100,000 deductible retirement plan contribution generates $163,000 in additional tax deductions!

Strategy #1: Reduce Taxable Income with Retirement Plan

Kathy’s $100,000 retirement contribution

– Generates $163,000 in new deductions

– Reduces Federal income tax by $47,570

- From $96,629 to $49,059

– Net “cost” of $100,000 contribution = $49,059 or $.49 cents on the dollar

Each $1.00 of retirement plan contributions can generate as much as $1.63 of tax deductions

(becomes a “Super Contribution”)

Strategy #1 Application

- Maximum retirement plan contributions generally achieved by pairing a 401(k) profit sharing plan with a cash balance pension plan
- Combined contributions/deductions depend on age and compensation but $200,000+ per year often available
- SSTBs with QBI up to $500,000+ are potential candidates for this strategy
- New plan(s) must be adopted by 12/31/2018

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Strategy #2: "Rothification"

Scenario: Taxable income lower than both QBI and the $157,500 or $315,000 applicable threshold

Example: CPA Carla files jointly with spouse:

- $275,000 QBI from CPA practice
- Taxable income $250,000
- Carla usually contributes $50,000 to a SEP or PSP
- QBI deduction without SEP or PSP = $50,000
- QBI deduction after $50,000 contribution = $40,000

Each $1.00 of deductible retirement contribution only reduces taxable income by $.80

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Strategy #2: “Rothification”

Strategy #2: Carla makes a $24,500 Roth 401(k) contribution and an In-Plan Roth Conversion of $25,000 to get her taxable income equal to her QBI:

- QBI and taxable income now both $275,000
- §199A deduction now $55,000

$1.00 of Roth 401(k) contribution or In-Plan Roth conversion only “costs” $.80 more in taxable income

Strategy #2 Application

- To make a 2018 Roth 401(k) contribution Carla has to adopt a 401(k) plan by 12/31/2018 (10/1/2018 if Carla has employee and needs the Safe Harbor)
- If previously using a SEP must roll SEP into new 401(k) PSP to enable In-Plan Roth conversion by 12/31/2018
- If currently using a SIMPLE IRA consider retroactively “blowing up” the SIMPLE for 2018?

Strategy #1 & #2 Table

Taxable Income Before Retirement Contribution	SSTB Retirement Contribution Strategy	Non-SSTB Without Wages Retirement Contribution Strategy	Non-SSTB With Wages Retirement Contribution Strategy
<$157,500 S < $315,000 J	Rothify	Rothify	Rothify
$157,501-$350,000 S $315,501-$515,000 J	Super Contribution	Super Contribution	Rothify
>$350,000 S >$515,000 J	Traditional	Traditional	Rothify or Traditional

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Strategy #3: SSTBs Avoid S-corp

- SSTBs should AVOID electing S-corp tax status
- Example: Married dentist Margaret expects to generate $250,000 of net income
- If taxed as an S-corp:
  - Margaret pays herself **$200,000** in W-2 wages*
  - QBI only **$50,000** (wages don't count)
- §199A deduction = 20% x $50,000 = **$10,000**

***IRS requires that S-corps pay owners "reasonable compensation" on W-2**

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Strategy #3: SSTBs Avoid S-corp

- **Better strategy:** Margaret forms an LLC taxed as a sole proprietorship
  - – $250,000 net practice income now all QBI
  - – §199A deduction increases from <u>$10,000 to $50,000</u>
    - Saves $9,600 in Federal income tax (24% x $40,000)
  - – Downside is additional $1,500 in Medicare tax on the additional $50,000 of Self-Employment income

Strategy #3 Application

- If SSTB already S-corp, too late to “de-elect” for 2018, wait until 1/1/2019
- Better strategy: Reduce wages by retirement plan contribution
- Margaret pays herself only $150,000 in wages and contributes $50,000 to her 401(k) PSP*
- §199A deduction still <u>$10,000</u>

- *Retirement plan contributions count towards “reasonable compensation”

Strategy #4: Non-SSTBs Need S-corp for Wages

Scenario: Non-SSTB has high income but pays no wages

Example: Jane is a married real estate agent

- $700,000 QBI (Schedule C)
- No employees or investment in business property
- Joint taxable income $650,000
- Wage/property limit fully phased-in (taxable income >$415,000)

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Strategy #4: Non-SSTBs Need S-corp for Wages

Jane's §199A deduction calculation

Lesser of 3 amounts:

1. 20% x $700,000 QBI = $140,000
2. 20% x $650,000 Taxable Income = $130,000
3. Greater of:
   - 50% x wages paid = $-0-
   - 25% x wages + 2.5% asset basis = $-0-

§199A deduction = **$-0-**

Federal income tax = $179,879

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Strategy #4: Non-SSTBs
Use S-corp for Wages

Strategy: Jane elects S-Corp tax status and pays herself $200,000 in wages:

- Same $700,000 total income ($200,000 W-2 wages and $500,000 pass-through income on S-Corp K-1)
- Joint taxable income still $650,000
- QBI deduction lesser of 20% x $500,000 QBI ($100,000) or 50% x $200,000 wages paid ($100,000)
- QBI deduction increased from zero to **$100,000**
- Federal income tax = $143,879 (**$36,000 savings**)

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Strategy #4: Non-SSTBs
Use S-corp for Wages

Application: To maximize QBI deduction for S-Corp owners subject to the wage limitation total wages (including owners) should be exactly **2/7 (28.57%)** of S-Corp pass-through income before the deduction for wages

In Jane's case there were no other employees so her optimum wages are 2/7 of the $700,000 S-Corp income

Caution: IRS requires S-Corp owners to take "reasonable compensation" as W-2 wages, is 2/7 reasonable?

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Strategy #5: Married Filing Separately

Scenario: Both spouses have business income

Example: Doctor Betty ($500K income) is married to real estate agent Sam ($150K income)

- Joint taxable income exceeds $415,000 full phase-in level
- No §199A deduction if file jointly
- If Sam files separately gets $30,000 §199A deduction (20% x $150,000)

Strategies Nixed by Regs

- Don't try to change from W-2 employee to independent contractor
- Don't try to separate non-SSTB aspects of SSTB business into related entities ("crack & pack" scheme)

Conclusions

- Each business owner's tax situation is unique and has to be individually analyzed
- Planning for and controlling taxable income is critical
- Planning needs to occur NOW (§199A deduction starts this year)

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Questions?

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