A Guide To The 20% Pass-Through Deduction

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Where Are We Today?

- December 2017: IRC Section 199A created by TCJA
- March 2018: "Grain glitch" fix attached to spending bill
- August 2018: ***Proposed*** regulations released by the IRS
  - IRS indicated they can be used to plan with… for now
  - Final regulations are likely to have some significant changes
  - Courts can rule that regulations are not in accordance with legislation
- October 16, 2018: 199A Hearings in D.C.

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Eligible Business Structures

- Sole proprietorships
- Limited liability companies
- S-Corporations
- Partnerships
- Other pass-through entities

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What Counts As QBI?

- *"The term 'qualified business income means, for any taxable year, the net amount of qualified items of income, gain, deduction, and loss* ***with respect to any qualified trade or business*** *of the taxpayer."*
- Proposed regulations state that a *"Trade or business means a section 162 trade or business other than the trade or business of performing services as an employee"*
- IRC Section 162 business
  - Engaged for profit
  - Regular
  - Continuous

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What Counts As QBI?

WHAT ADVISOR COMPENSATION IS ELIGIBLE FOR THE QBI DEDUCTION

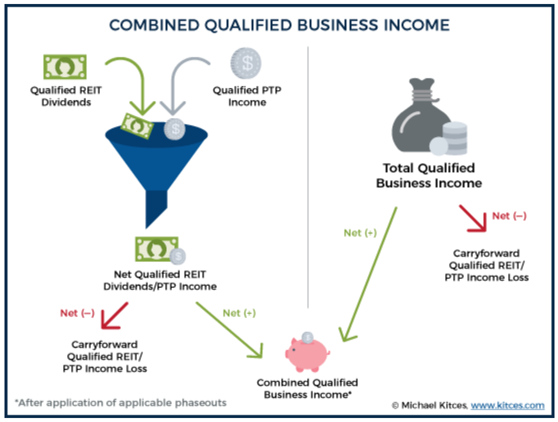
Type of Business	Qualified Business Income	NOT Qualified Business Income	QBI Amount Found On
Non-Owner, Employee Advisor	Ineligible	Ineligible	N/A
C-Corporation Owner/ Employee	Ineligible	Ineligible	N/A
Sole Proprietor	Net Profit	N/A	Schedule C, Line 31
Partner	Ordinary Business Income	Guaranteed Payments	Schedule K-1, Line 1
S-Corporation Owner	Ordinary Business Income (Profits)	Wages	Schedule K-1, Line 1

Note: Qualified business income attributable to financial services is only eligible for the QBI deduction if total household taxable income is below the advisor's applicable threshold.

Basic Mechanics of the Deduction

- Deduction equals the lessor of 20%:
  - "Combined qualified business income"
    - QBI
    - Combined qualified REIT/PTP income
  - Taxable income (before the application of the pass-through deduction), less capital gains

Basic Mechanics of the Deduction



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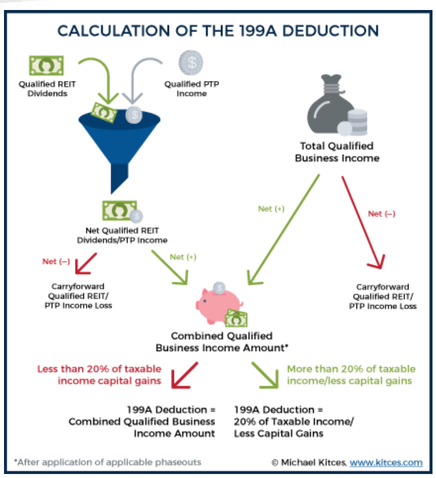
Basic Mechanics of the Deduction



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Where Is the Deduction Taken?

- Personal deduction for business income
  - Deduction goes on personal income tax return
  - Business owners with similar roles, equity and profits may have vastly different deductions
- ~~An "in between the line deduction"~~
- A "below-the-below-the-line deduction"

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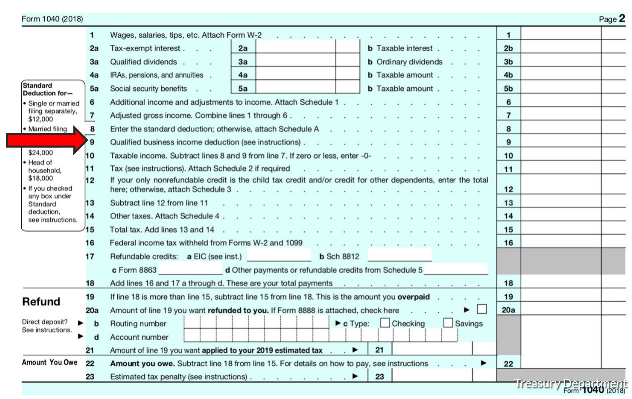
The New 1040


Form 1040 (2018) Page 2

1	Wages, salaries, tips, etc. Attach Form W-2		1
2a	Tax-exempt interest	2a	b Taxable interest 2b
3a	Qualified dividends	3a	b Ordinary dividends 3b
4a	IRAs, pensions, and annuities	4a	b Taxable amount 4b
5a	Social security benefits	5a	b Taxable amount 5b
6	Additional income and adjustments to income. Attach Schedule 1		6
7	Adjusted gross income. Combine lines 1 through 6		7
8	Enter the standard deduction; otherwise, attach Schedule A		8
9	Qualified business income deduction (see instructions)		9
10	Taxable income. Subtract lines 8 and 9 from line 7. If zero or less, enter -0-		10
11	Tax (see instructions). Attach Schedule 2 if required		11
12	If your only nonrefundable credit is the child tax credit and/or credit for other dependents, enter the total here; otherwise, attach Schedule 3		12
13	Subtract line 12 from line 11		13
14	Other taxes. Attach Schedule 4		14
15	Total tax. Add lines 13 and 14		15
16	Federal income tax withheld from Forms W-2 and 1099		16
17	Refundable credits: a EIC (see inst.) b Sch 8812 c Form 8863 d Other payments or refundable credits from Schedule 5		
18	Add lines 16 and 17 a through d. These are your total payments		18
19	If line 18 is more than line 15, subtract line 15 from line 18. This is the amount you **overpaid**		19
20a	Amount of line 19 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐		20a
b	Routing number ▶ c Type: ☐ Checking ☐ Savings		
d	Account number		
21	Amount of line 19 you want **applied to your 2019 estimated tax** ▶	21	
22	**Amount you owe.** Subtract line 18 from line 15. For details on how to pay, see instructions ▶		22
23	Estimated tax penalty (see instructions) ▶	23	

Standard Deduction for—
• Single or married filing separately, $12,000
• Married filing … $24,000
• Head of household, $18,000
• If you checked any box under Standard deduction, see instructions.

Refund

Direct deposit? See instructions.

Amount You Owe

Treasury Department

Form 1040 (2018)

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"Low" Income Clients

- Threshold for married-joint filers - $315,000*
- Threshold for all others - $157,500*

- Type of business does not matter
  - Specified service trade or business (SSTB)
  - Non-specified service trade or business (non-SSTB)
- No need to analyze other business attributes
  - W-2 wages
  - Depreciable property

*Taxable income

High-Income Clients: Non-SSTB

- Full deduction can be "saved" with W-2 wages paid and/or depreciable assets owned
  - 50% of W-2 wages paid, OR
  - 25% of W-2 wages paid, plus 2.5% of the unadjusted basis of depreciable property

- Partial-to-full deduction is available for clients with taxable income within the phase-out range
  - Sliding scale formula

Breaking Down the QBI Deduction Tests

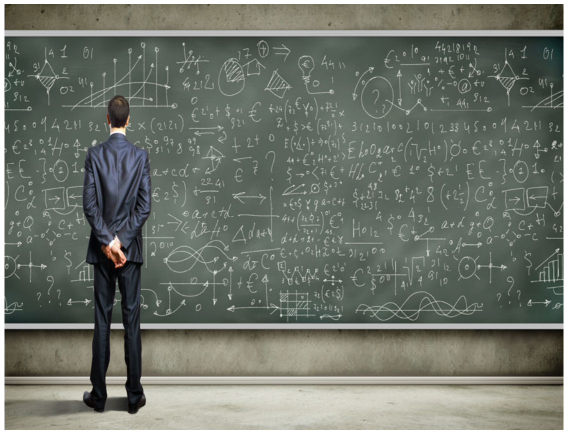
- Wages
  - Look at the W-3
- Unadjusted basis of depreciable property immediately after acquisition
  - Tangible property only
  - Property must be owned at end of year*
  - Only counts within the depreciable period
    - Greater of actual depreciable period or 10 years
    - Additional first-year depreciation does not impact the depreciable period

*Anti-abuse rule

High-Income Clients: SSTBs

- Clients with taxable income above the upper-end of their phaseout range get NO deduction
- Partial deduction is available for clients with taxable income within the phase-out range
  - Married-joint phaseout range: $100,000
  - All other filers phaseout range: $50,000
  - Phaseout range "double-dinge"
    - QBI reduction
    - Wage and depreciable property reduction

Calculation For SSTB With Income In the Phaseout Range



Calculation For SSTB With Income In the Phaseout Range

- Ned is a Sole Proprietor Financial Advisor
- Practice generates $160,000 of QBI (net profit)
- Practice pays $60,000 of W-2 wages
  - No depreciable property
- Total taxable income is 192,500
- 70% through phaseout range

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Calculation For SSTB With Income In the Phaseout Range

- Step #1: Calculate the "applicable percentage" by reducing QBI by 70%
  - ➢$48,000 ($160,000 x (1 - .7) = $48,000)
- Step #2: Reduce wages and depreciable property by 70%
  - ➢$18,000 ($60,000 x (1 - .7) = $18,000)

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Calculation For SSTB With Income In the Phaseout Range

BEGIN "NORMAL" TESTING

- Step #3: Calculate deduction without limitation
  - – $9,600 ($48,000 x 20% = $9,600)
- Step #4: Calculate the "Excess Amount"
  - – Amount that exceeds testing
  - ➢$600 ($9,600 - $9,000 = $600)

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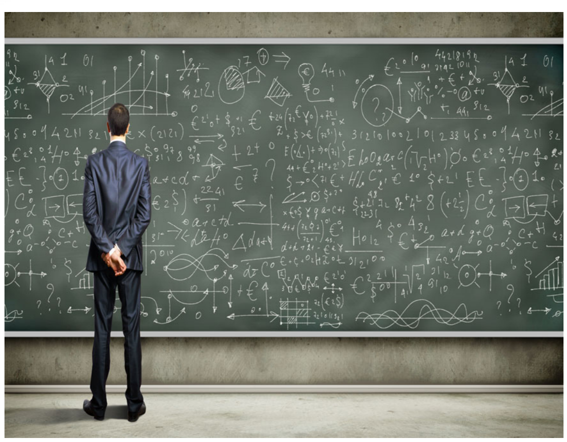
Calculation For SSTB With Income In the Phaseout Range

- Step #5: Reduce potential QBI deduction by excess amount
  - $9,180 ($9,600 – ($600 x .7) = $9,180)

Actual QBI deduction

Calculation For SSTB With Income In the Phaseout Range



Specified Service Trade or Businesses (SSTBs)

- The pass-through deduction "kiss of death"
  - Exception for "low" income taxpayers

- Health
- Law
- Accounting
- Actuarial science
- Performing arts
- Consulting
- Athletics
- Financial Services

- Any other field where the principal asset of the business is the reputation or skill of one or more of its employees

A Closer Look At Select SSTBs

- "Health" includes:
  - Doctors
  - Nurses
  - Dentists
  - Veterinarians
  - Pharmacists
  - Physical therapists
  - Psychologists

A Closer Look At Select SSTBs

- "Accounting" includes:
  - Enrolled agents
  - Return preparers
  - Financial auditors
- "Law" includes:
  - Paralegals
  - Legal arbitrators
  - mediators

A Closer Look At Select SSTBs

- Financial Services include:
  - Investment management
  - "Trading and dealing in securities, partnerships or commodities"
  - Brokers of securities
  - "Financial advisors"
  - "Investment bankers"
  - "Retirement advisors"
  - "Wealth planners"
  - Those "receiving fees for investing, asset management, or investment management services, including providing advice with respect to buying and selling investments"

A Closer Look At Select SSTBs

- Financial Services **DOES NOT** include:
  - Real estate agents
  - Real estate brokers
  - Traditional bankers (not investment bankers)
  - Insurance agents
  - Insurance brokers

"Principal-Asset-Is-The-Reputation-Or-Skill" Provision

- Legislative text
  - "any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees"
- Caused high level of concern among practitioners due to potentially high level of subjectivity
- Concerns largely alleviated by the proposed regulations

"Principal-Asset-Is-The-Reputation-Or-Skill" Provision

- Proposed regulations take an extremely narrow view
- SSTB by virtue of skill/reputation provision if and only if income is generated via
  - Endorsements of products or services
  - Use of an individual's image, likeness, name, signature, voice, trademark, or any other symbol associated with the individual's identity
  - Appearances on radio, television, or other media

SSTB By Virtue Of Rule

1. De Minimis rule
2. Incidental-to-SSTB rule
3. 80/50 rule

SSTB De Minimis Rule

- Makes a multi-line business an SSTB by rule
- Gross *revenue* ≤ $25 million
  - SSTB if SSTB revenue ≥ 10% of gross revenue
- Gross *revenue* > $25 million
  - SSTB if SSTB revenue ≥ 5% of gross revenue
- Annual test!

Strategies For Dealing With The SSTB De Minimis Rule

- Eliminate the line of business
- Split the activities into legitimate, bone fide, *separate* businesses
  - Separate books for each activity
  - Generally need to invoice customers separately
  - Generally need to pay bills separately
  - Must not run afoul of the "incidental-to-SSTB " Rule

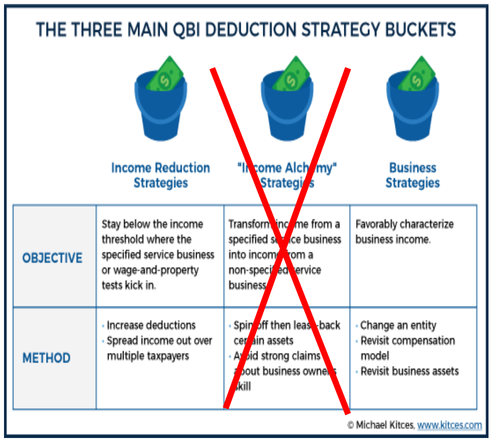
Incidental-To-SSTB Rule

- 50% or more common ownership between SSTB and "non-SSTB"
- Shared expenses
- "Non-SSTB" revenue ≤ 5% of combined revenue

80/50 Rule

- The "Spin-off Killer", a.k.a. the "Anti-Crack-and-Pack"
- A business is deemed an SSTB if:
  - It has 50% or more common ownership with an SSTB
  - The "non-SSTB" provides 80% or more of its property or services to the SSTB
  - Partial SSTB treatment if ≥50% common ownership but less than 80% property/services provided

Planning Opportunities



	Income Reduction Strategies	"Income Alchemy" Strategies	Business Strategies
OBJECTIVE	Stay below the income threshold where the specified service business or wage-and-property tests kick in.	Transform income from a specified service business into income from a non-specified service business.	Favorably characterize business income.
METHOD	· Increase deductions · Spread income out over multiple taxpayers	· Spin off then lease-back certain assets · Avoid strong claims about business owner's skill	· Change an entity · Revisit compensation model · Revisit business assets

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Revisit Married-Filing-Separate

- Generally results in higher combined tax bill than filing a joint return
- "…the term 'threshold amount' means $157,500 (200 percent of such amount in the case of a joint return)."
  - No penalty for married-filing-separate vs. individual filers!

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Revisit Married-Filing-Separate

- Example:
  - Bill and Sally are married
  - Will earns $400,000 as W-2 employee
  - Sally is a sole-proprietor CPA with $175,000 of net business profit
- If they file joint, Bill's salary wipes out any QBI deduction

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Revisit Married-Filing-Separate

POTENTIAL TO REDUCE TAX LIABILITY BY FILING SEPARATE VS. FILING JOINT

2018	Case 1		Case 2
Filing Status	Separate	Separate	Joint
Ordinary Income	$ 400,000	$ 164,696	$ 564,696
Net Short-Term Gain or Loss	$ -	$ -	$ -
Net Long-Term Gain or Loss	$ -	$ -	$ -
Adjusted Gross Income	$ 400,000	$ 164,696	$ 564,696
Itemized Deductions	$ -	$ -	$ -
Standard Deduction	$ 12,000	$ 12,000	$ 24,000
Qualified Income Deduction	$ -	$ 30,539	$ -
Taxable Income	$ 388,000	$ 122,157	$ 540,696
AMTI Net of Exemption	$ 345,300	$ 79,457	$ 455,296
Schedule or Table Tax	$ 113,250	$ 23,607	$ 140,623
Tentative Minimum Tax	$ 94,773	$ 20,659	$ 123,661
Self-Employment and Other Taxes	$ 2,475	$ 20,938	$ 23,413
Net Federal Tax	$ 115,725	$ 44,545	$ 164,036

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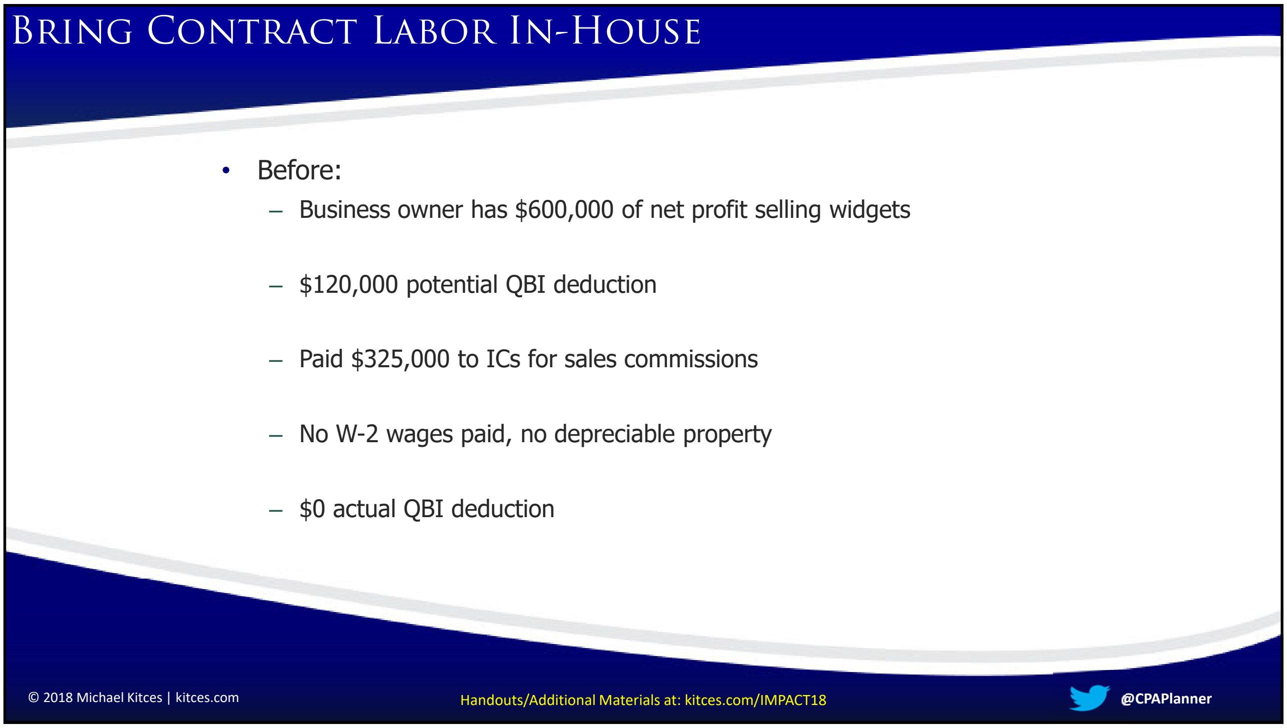
Salaried Employee to Independent Contractor

- W-2 compensation is not eligible for the QBI deduction
- Profits from sole proprietorships may be eligible for the QBI deduction
- Be mindful of differences in:
  - Employment taxes
  - Deductibility of business expenses
  - Other employee benefits lost
- Must overcome the *presumption* that the contractor is an employee when providing services to the same company

Bring Contract Labor In-House

- Consideration for high-income business owners of non-SSTB
- Contract labor cannot help "save" the QBI deduction
  - W-2 wages paid can!


BRING CONTRACT LABOR IN-HOUSE
• Before:
– Business owner has $600,000 of net profit selling widgets
– $120,000 potential QBI deduction
– Paid $325,000 to ICs for sales commissions
– No W-2 wages paid, no depreciable property
– $0 actual QBI deduction
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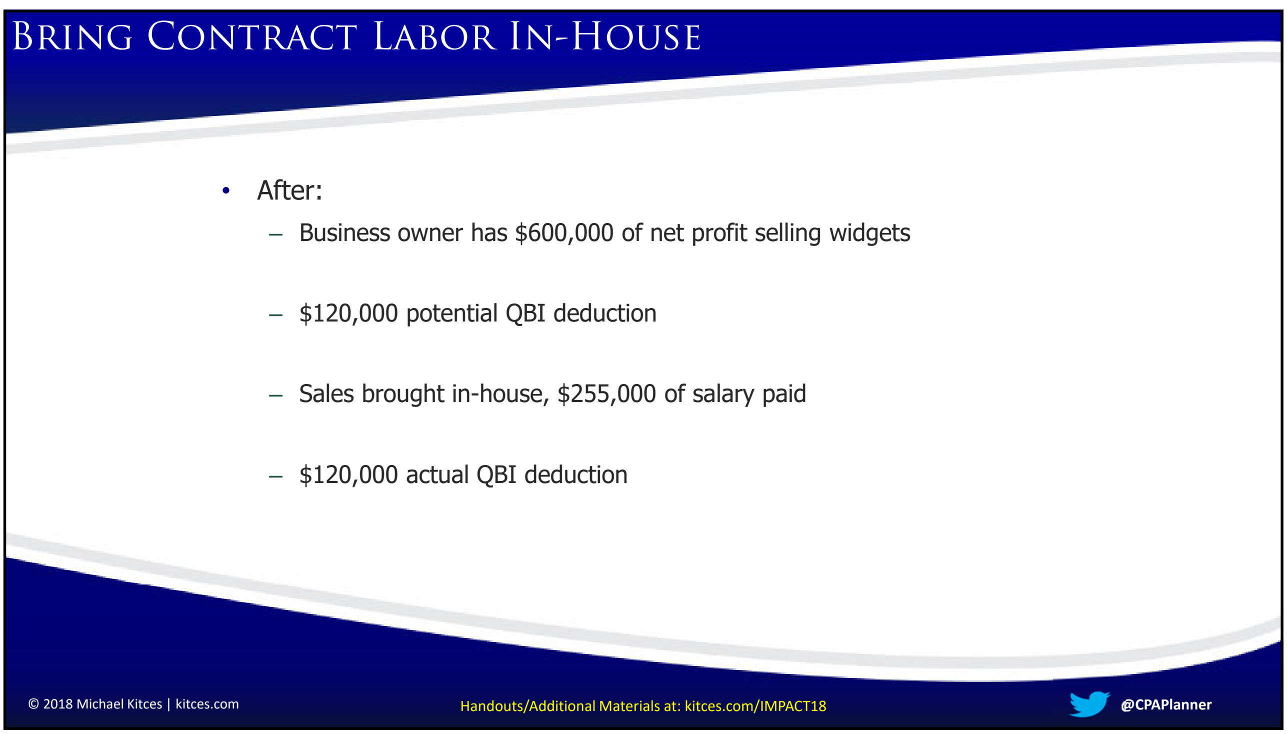
BRING CONTRACT LABOR IN-HOUSE
• After:
– Business owner has $600,000 of net profit selling widgets
– $120,000 potential QBI deduction
– Sales brought in-house, $255,000 of salary paid
– $120,000 actual QBI deduction
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Non-Salary-Paying Entities To S Corporations

- Certain types of business owners are not eligible to pay themselves a salary
  - Sole proprietors
  - Owners of businesses taxed as partnerships
- 3 key questions:
  - Is the entity one that restricts the business owner from paying themselves a salary?
  - Is the business not a specialized trade or service business?
  - Does the business owner have taxable income in excess of their threshold amount?

Non-Salary-Paying Entities To S Corporations

- Before:
  - Sole proprietor business owner has $750,000 of net profit selling widgets
  - $150,000 potential QBI deduction
  - No W-2 wages paid, no depreciable property
  - $0 actual QBI deduction

Non-Salary-Paying Entities To S Corporations

- After:
  - S corporation established
  - Business owner pays themselves a $300,000 salary
    - 50% x $300,000 = $150,000
  - $450,000 of net profit to owner
  - $90,000 potential QBI deduction
  - $90,000 actual QBI deduction

Determining The "Perfect" Salary

- Take owner's combined profit (before salary)
- Multiply by 28.57%
  - 28.5714285714286%
- Result is the "perfect" salary

Determining The "Perfect" Salary

- Sole proprietor business owner has $750,000 of net profit
- S corporation established
  - Business owner pays themselves a $214,275 ($750,000 x 28.57%) salary
    - 50% x $ 214,275 = $107,138
  - $535,725 of net profit to owner
  - $107,145 potential QBI deduction
  - $107,138 actual QBI deduction

S Corporation To LLC Or Partnership

- Only S corporation profits are eligible for the QBI deduction
- Partnership income (other than guaranteed payments) is eligible for the QBI deduction
- Particularly attractive for S corporation owners with salaries close to or above the annual Social Security earnings cap
  - $128,400 in 2018

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S Corporation To LLC Or Partnership

- Before:
  - S corporation business owner
  - $110,000 salary
  - $10,000 profit
  - $2,000 tentative QBI deduction
- After:
  - Entity converted to partnership
  - $120,000 of partnership income
  - $24,000 tentative QBI deduction
- Key question: Does the larger QBI deduction more than offset the increase in employment taxes?

Revisit Retirement Plans

- Same old strategy. New bigger benefit!
- Extremely valuable for those in or just above phase-out range
- Key goal of tax planning… pay taxes at the lowest rates possible
- 47.57% marginal rate (Federal) for income within QBI deduction phase-out range

Revisit Retirement Plans

- Before:
  - Married couple filing joint return
  - $439,000 gross income, all QBI from specified service business
    - $24,000 standard deduction
  - No retirement account contributions
  - $415,000 taxable income
    - $0 QBI deduction
  - $96,629 in Federal income tax (w/out SE tax)

Revisit Retirement Plans

- After:
  - Same $439,000 gross income, all QBI from specified service business
    - $24,000 standard deduction
  - $100,000 in cumulative 401(k) contributions
  - $315,000 taxable income
    - $63,000 QBI deduction
  - $49,059 in Federal income tax (w/out SE tax)

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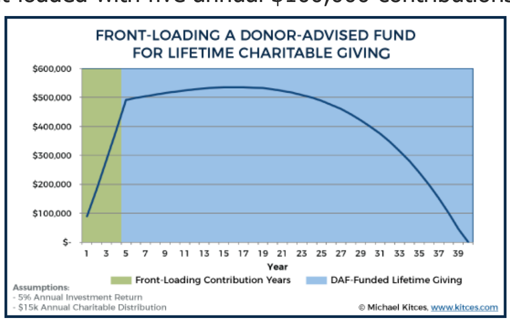
Bunch Charitable Contributions

- Works best for those already itemizing deductions
- Below-the-line deductions can help business owners qualify for the QBI deduction!
- Consider the expanded use of donor-advised funds

Bunch Charitable Contributions

- Example
  - Goal: Annual contributions of $15,000
  - Front-loaded with five annual $100,000 contributions



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Utilize Aggregation Rules

- Allows taxpayer to aggregate (group) multiple businesses together for testing purposes
- New businesses may be added to group at time of acquisition
- Existing group must generally remain in tact unless one or more businesses no longer qualify to be aggregated

Utilize Aggregation Rules

- To aggregate, the businesses must:
  - Have ≥ 50% common ownership for a majority of the tax year
  - All relevant items must be aggregated
  - Can't include *any* SSTBs

PLUS

- At least 2 of the following 3 must apply to the businesses being aggregated
  - They provide products and services that are customarily offered together
  - They share facilities or significant centralized business elements
  - They operate in coordination with, or reliance upon, one or more of the businesses in the aggregated group

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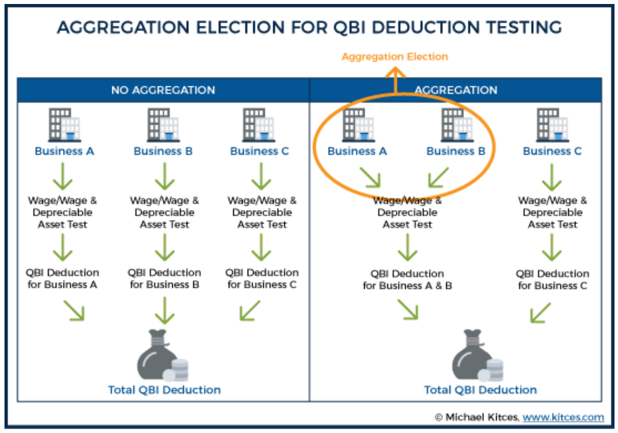
Utilize Aggregation Rules



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Reduce Guaranteed Partnership Payments

- "Regular" partnership income is QBI
  - Schedule K-1, Box 1
- Guaranteed payments to partners are not QBI
  - Schedule K-1, Box 4
- Reducing/eliminating guaranteed payments can increase QBI

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Reduce Guaranteed Partnership Payments

- Before:
  - Sean owns 70% of SH Services
  - Harry owns 30% of SH Services
  - Each partner receives $100,000 of guaranteed payments
  - SH has 2018 profit of $80,000 after making guaranteed payments
  - $56,000 profit to Sean
    - $11,200 potential QBI deduction
  - $24,000 profit to Harry
    - $4,800 potential QBI deduction

Reduce Guaranteed Partnership Payments

- After:
  - Sean owns 55.7% of SH Services
  - Harry owns 44.3% of SH Services
  - SH has 2018 profit of $280,000
  - $156,000 profit to Sean
    - $31,200 potential QBI deduction
  - $124,000 profit to Harry
    - $24,800 potential QBI deduction

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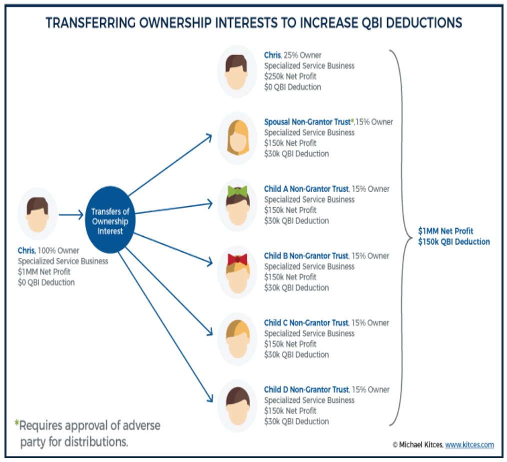
Reduce Guaranteed Partnership Payments

- Be sure to consider potential side effects!!!
- What happens if partnership income falls?
- What happens if partnership income increases?
- Will the transfer of ownership be structured as a purchase, or a gift?

Consider The Use Of Non-Grantor Trusts

- In the case of a taxpayer other than a corporation, there shall be allowed as a deduction for any taxable year…"
- Transfer ownership interests to non-grantor trusts
  - Each trust gets its own taxable income limit
  - Potential for $31,500 of QBI deduction per trust

Consider The Use Of Non-Grantor Trusts



Non-Grantor Trusts: Words of Caution

- Special rules apply to non-grantor trusts with a spousal trust beneficiary
  - Adverse party approval necessary for distributions
- 643(f) can collapse multiple trusts when:
  - The trusts are established by substantially the same grantor(s), AND
  - The trusts are established for substantially the same trust beneficiaries, AND
  - The principal purpose of the trust is tax avoidance (not evasion)
- The grantor is giving away income
  - Can they afford to?
  - Do they want to?

Family Income Shifting

- Hire children for bona fide services
  - Cleaning, shredding, filing, copying
- Children can potentially earn up to $12,000 and pay $0 in tax
- Reduces parents income
  - Way better than an allowance!

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Minimize Portfolio Income

- QBI phase-out range is based on taxable income
  - Includes income taxed at LTCG rates
- Greater emphasis on tax-loss harvesting
- Controlling taxable income with synthetic dividends
- Increased benefit of municipal bonds
- Low-cost, investment-only VAs

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Revisit Asset Location

COMPARISON OF QUALIFIED REIT DIVIDENDS* VS. QUALIFIED DIVIDENDS*

Ordinary Income Tax Rate	Effective Rate for Ordinary Income After QBI Deduct.	Qualified Dividened Rate	Difference
10%	8.0%	0%	8.0%
12%	9.6%	0%	9.6%
22%	17.6%	15%	2.6%
24%	19.2%	15%	4.2%
33%	26.4%	15%	11.4%
35%	28.0%	15%	13.0%
37%	29.6%	20%	9.6%

*Both qualified REIT dividends and qualified dividends are generally subject to the additional 3.8% surtax on net invementment income as an investor's modified adjusted gross income exceeds their applicable threshold.

Miscellaneous QBI Deduction Issues

- The deduction is NOT subject to AMT
- The deduction is eliminated beginning in 2026
  - C corporations use would likely increase

Questions?

Handouts & additional materials:
www.kitces.com/IMPACT18

Contact: questions@kitces.com

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