A Guide To The 20% Pass-Through Deduction

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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?

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

- Applies to the lessor of:
  - Eligible (qualified) business income
  - Taxable income (before the application of the pass-through deduction), less capital gains

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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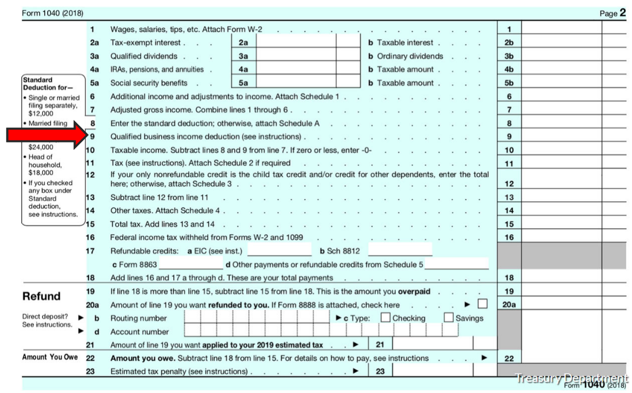
The New 1040


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
Standard Deduction for—	5a	Social security benefits . . 5a	b Taxable amount	5b
• Single or married filing separately, $12,000	6	Additional income and adjustments to income. Attach Schedule 1		6
• Married filing	7	Adjusted gross income. Combine lines 1 through 6		7
	8	Enter the standard deduction; otherwise, attach Schedule A		8
$24,000	9	Qualified business income deduction (see instructions)		9
• Head of household, $18,000	10	Taxable income. Subtract lines 8 and 9 from line 7. If zero or less, enter -0-		10
• If you checked any box under Standard deduction, see instructions.	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
Refund	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
Direct deposit? See instructions. ▶	b	Routing number	▶ c Type: ☐ Checking ☐ Savings	
▶	d	Account number		
	21	Amount of line 19 you want **applied to your 2019 estimated tax** ▶ 21		
Amount You Owe	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		

Treasury Department Form 1040 (2018)

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"Low" Income Clients

- Threshold for married-joint filers - $315,000*
  - $100,000 phase-out range
- Threshold for all others - $157,500*
  - $50,000 phase-out range

- Type of business does not matter
- No need to analyze other business attributes
  - W-2 wages
  - Depreciable property

- *Taxable income

High-Income Clients: Specified Service Business

- Clients with taxable income above their applicable threshold will get NO deduction

- Partial deduction is available for clients with taxable income within the phase-out range
  - Deduction ratably decreased within phase-out range

Specified Service Business

- 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

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High-Income Clients: Non-Specified Service Business

- Clients with taxable income above their applicable threshold may receive NO deduction
- 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

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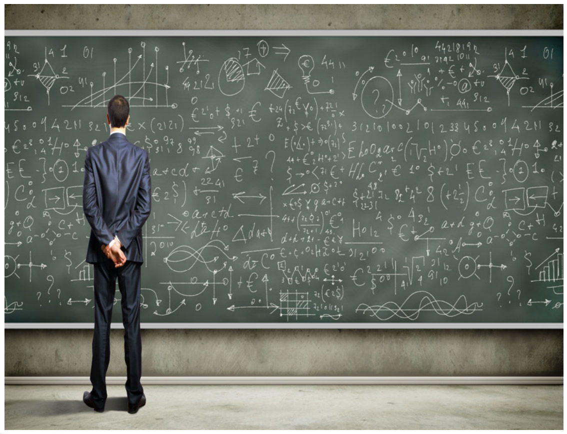
Planning Opportunities



Planning Opportunities

THE THREE MAIN QBI DEDUCTION STRATEGY BUCKETS

	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

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

Bring Contract Labor In-House

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

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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?

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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

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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

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Determining The "Perfect" Salary

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

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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

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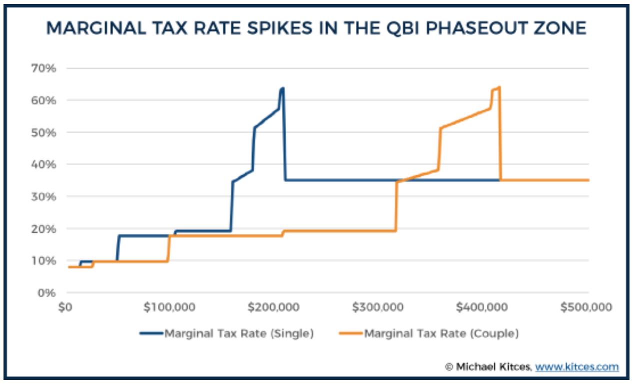
S Corporation To LLC Or Partnership

- 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

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?

Marginal Tax Rates Within Phaseout Range



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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 for income within QBI deduction phase-out range

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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)

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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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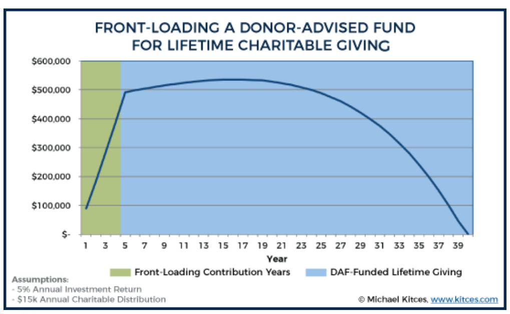
Bunch Charitable Contributions

- 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



"Income Alchemy"

- How do we take specified service business income and turn it into non-specified service business income
  - Only matters for high-income clients
- Create other companies with common ownership that are not specified service businesses
  - Have "main" company engage new companies for services

"Income Alchemy" Strategies

- Spin off real estate to a new entity
  - Lease-back the real estate to the "main" business
  - Rent must be reasonable
- Spin off other depreciable property to a new entity
  - Lease-back the property to the "main" business
  - Rent must be reasonable

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"Income Alchemy" Strategies

- Create an employee leasing company (a.k.a. a PEO) and lease employees from the company
  - Have the PEO charge the "main" business a reasonable markup on employees
  - Not entirely clear how the IRS will treat these wages
- Create IP using "outside" companies and license the IP to the specified service business
  - IP company can charge the "main" business a reasonable royalty

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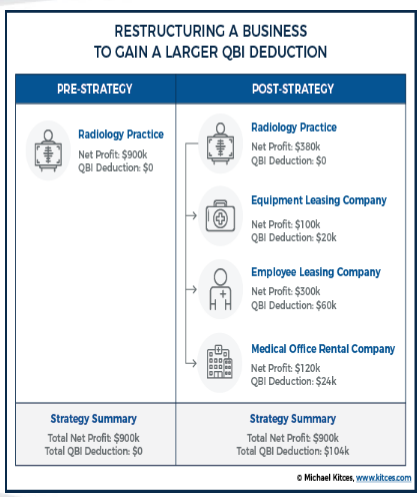
"Income Alchemy"



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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

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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?

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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…" (emphasis added)
- Transfer ownership interests to non-grantor trusts
  - Each trust gets its own taxable income limit
  - Potential for $31,500 of QBI deduction per trust

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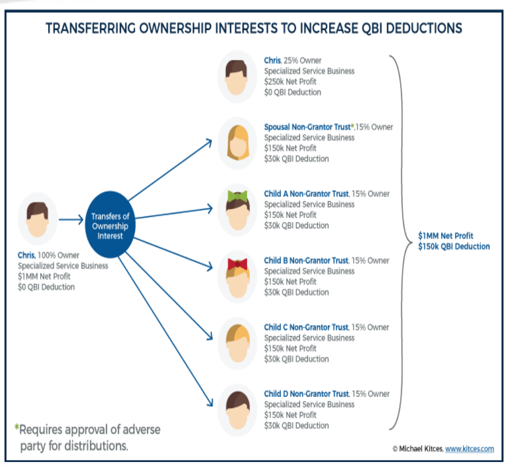
Consider The Use Of Non-Grantor Trusts



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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?

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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
- Asset location strategies

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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!

Other QBI Deduction Strategies

- Consider forgoing bonus depreciation
- Play "dumb" in advertising for on-the-fence types of businesses
- Make use of other deductions to keep taxable income low

Summary of QBI Deduction Strategies

Income Reduction Strategies	Revisit filing separate returns for married couples	Beef up retirement plan contributions (especially at or close to phase-out ranges)	Transfer portions of ownership to various non-grantor trusts	Manage portfolio income	Consider passing on bonus depreciation to lower income in multiple years	Hire children for bone fide work	Consider donor-advised funds and other strategies to lower taxable income
"Income Alchemy" Strategies	Spin-off business-owned real estate into a separate entity and lease-back the property	Spin-off business owned depreciable equipment/property into a separate entity lease-back to equipment/property	Create an employee leasing company. Contract with the employee leasing company to provide staff	Avoid celebrity and high-profile employees	Avoid marketing language that makes strong claims about a business owner's skills		
Business Decisions	Switch from salaried employee to independent contarctor	Reduce independent contract labor in favor of hiring more W-2 employees	Converting non-salary-paying sole proprietors, LLCs, or partnerships, into S corporations	Change profit-eligible-only S corporations to partnerships	Reduce or eliminate guaranteed payments to partners		

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Grey Areas Of The Law

- What definition of "trade or business" will the IRS use?
  - Will Schedule E rental income automatically qualify?
- How will the basis of property be treated after a 1031 exchange?
- How will IRS guidance change things?
- How do we deal with businesses with a fiscal year?
- How will Section 1231 gain be treated?
- How will the deduction impact a partner/S corporation shareholder's basis?

Miscellaneous QBI Deduction Issues

- Carryover of losses will reduce QBI deduction in future years
- The deduction is NOT subject to AMT
- The deduction is eliminated beginning in 2026
  - C corporations use would likely increase

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