

# 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.

## ELIGIBLE BUSINESS STRUCTURES

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

## 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

## WHAT COUNTS AS QBI?

### WHAT ADVISOR COMPENSATION IS ELIGIBLE FOR THE QBI DEDUCTION

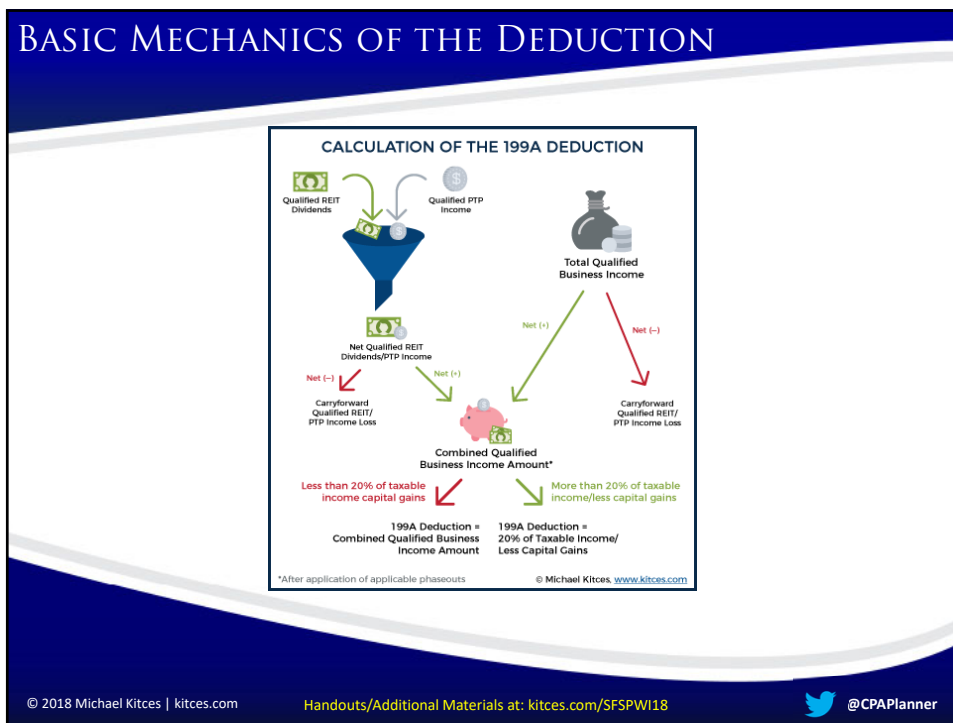
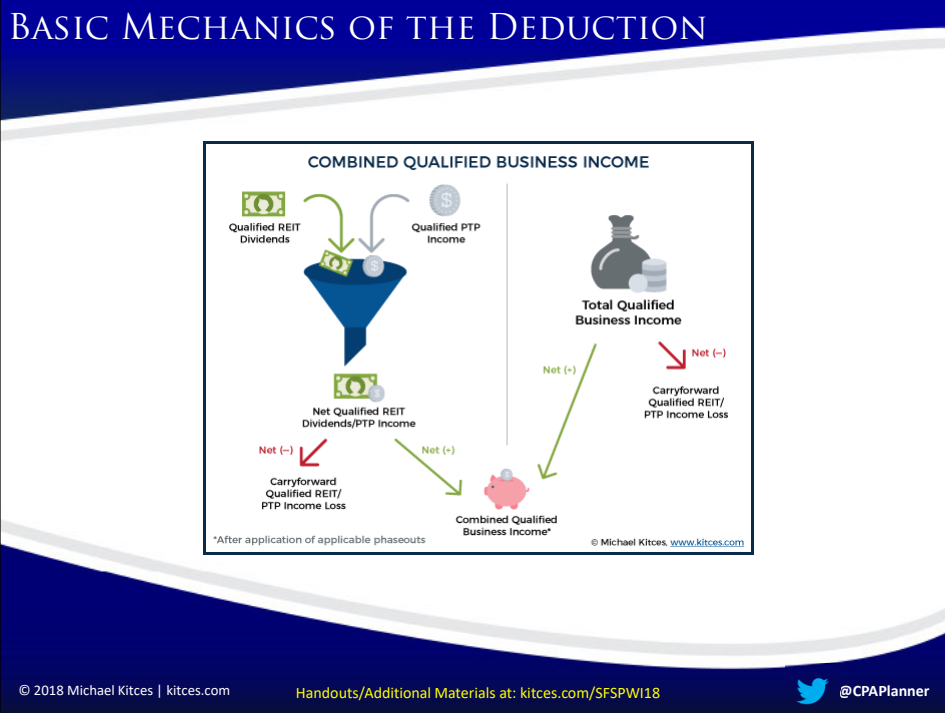
Type of Business	Qualified Business Income	NOT Qualified Business Income	QBI Amount Found On
Non-Owner, Employee Advisor	Ineligible	Ineligible	N/A
C-Corporation Owner/Employee	Ineligible	Ineligible	N/A
Sole Proprietor	Net Profit	N/A	Schedule C, Line 31
Partner	Ordinary Business Income	Guaranteed Payments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

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## BASIC MECHANICS OF THE DEDUCTION

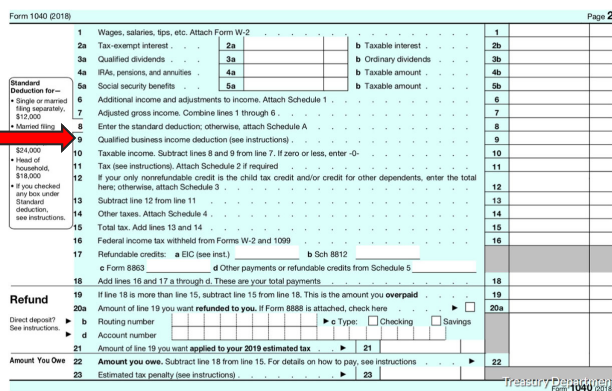
- Deduction equals the lesser of 20%:
  - “Combined qualified business income”
    - QBI
    - Combined qualified REIT/PTP income
  - Taxable income (before the application of the pass-through deduction), less capital gains



## 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"

## THE NEW 1040



The image shows a portion of the 2018 Form 1040. A red arrow points to the 'Standard Deduction for' box, which contains the following information:

- Standard Deduction for:
  - Single or married filing separately: \$12,000
  - Married filing jointly: \$24,000
  - Head of household: \$18,000
- \* If you checked any box under Standard deduction, see instructions.

The rest of the form is partially visible, showing lines 1 through 23.

## “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



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## 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 ( $\$160,000 \times (1 - .7) = \$48,000$ )
  
- Step #2: Reduce wages and depreciable property by 70%
  - \$18,000 ( $\$60,000 \times (1 - .7) = \$18,000$ )

## CALCULATION FOR SSTB WITH INCOME IN THE PHASEOUT RANGE

### BEGIN "NORMAL" TESTING

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

## CALCULATION FOR SSTB WITH INCOME IN THE PHASEOUT RANGE

- Step #5: Reduce potential QBI deduction by excess amount

$$- \$9,180 (\$9,600 - (\$600 \times .7) = \$9,180)$$



**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

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## 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”

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## 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*  $\leq$  \$25 million
  - SSTB if SSTB revenue  $\geq$  10% of gross revenue
- Gross *revenue*  $>$  \$25 million
  - SSTB if SSTB revenue  $\geq$  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  $\leq$  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  $\geq$ 50% common ownership but less than 80% property/services provided




## PLANNING OPPORTUNITIES

**THE THREE MAIN QBI DEDUCTION STRATEGY BUCKETS**






Income Reduction  
Strategies




~~"Income Alchemy"  
Strategies~~



Business  
Strategies


<b>OBJECTIVE</b>	Stay below the income threshold where the specified service business or wage-and-property tests kick in.	<del>Transform income from a specified service business into income from a non-specified service business.</del>	Favorably characterize business income.
<b>METHOD</b>	<ul style="list-style-type: none"> <li>- Increase deductions</li> <li>- Spread income out over multiple taxpayers</li> </ul>	<ul style="list-style-type: none"> <li><del>- Spin off then lease back certain assets</del></li> <li><del>- Avoid strong claims about business owner's skill</del></li> </ul>	<ul style="list-style-type: none"> <li>- Change an entity</li> <li>- Revisit compensation model</li> <li>- Revisit business assets</li> </ul>

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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

## REVISIT MARRIED-FILING-SEPARATE

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

2018	Case 1		Case 2
	Separate	Separate	Joint
Filing Status			
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
    - $50\% \times \$300,000 = \$150,000$
  - \$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 ( $\$750,000 \times 28.57\%$ ) salary
    - $50\% \times \$214,275 = \$107,138$
  - \$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

## 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)

## 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

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## BUNCH CHARITABLE CONTRIBUTIONS

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

FRONT-LOADING A DONOR-ADVISED FUND FOR LIFETIME CHARITABLE GIVING

Assumptions:  
 - 5% Annual Investment Return  
 - \$15k Annual Charitable Distribution

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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

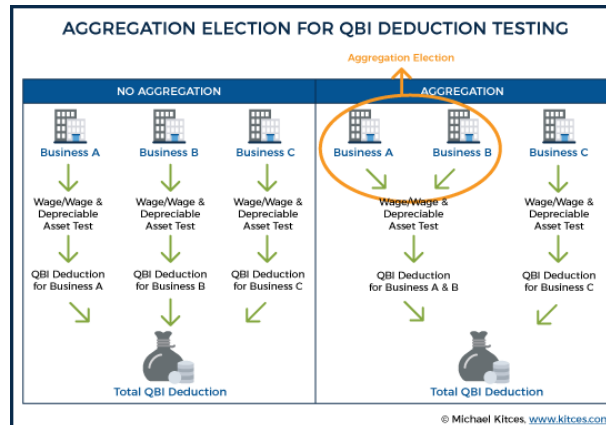
## UTILIZE AGGREGATION RULES

- To aggregate, the businesses must:
  - Have  $\geq 50\%$  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

## 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

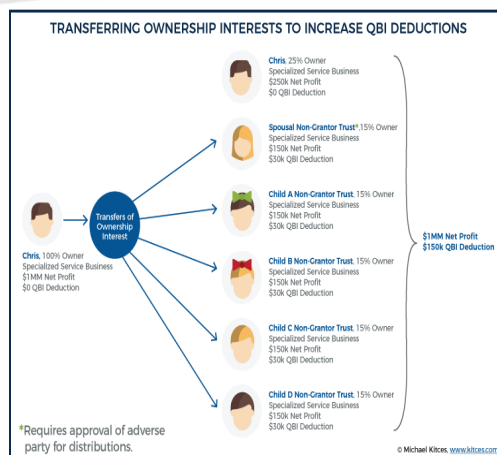
## REDUCE GUARANTEED PARTNERSHIP PAYMENTS

- 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



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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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## 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!

## 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



## 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 investment income as an investor's modified adjusted gross income exceeds their applicable threshold.

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## 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?

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Contact: [questions@kitces.com](mailto:questions@kitces.com)