

October 25th, 2018

Understanding and Planning for the New Federal 20% Business Deduction



TAX CUTS & JOBS ACT

MORE jobs | FAIRER taxes | BIGGER paychecks

A R M

RELATIONSHIPS | built on results

An Independent Member of BKR International

Disclaimer

A R M

- This document and information is provided by Ary Roepcke Mulchaey, P.C. and the presenter for general guidance only, and does not constitute the provision of legal advice, accounting services, investment advice, written tax advice, or professional advice of any kind.
- The information provided herein should not be used as a substitute for consultation with professional tax, accounting, legal, or other competent advisors.
- Before making any decision or taking any action, you should consult with a professional adviser who has been provided with all pertinent facts relevant to your particular situation.
- The information is provided “as is” with no assurance or guarantee of completeness, accuracy, or timeliness of the information, and without warranty of any kind, express or implied, including but not limited to warranties of performance, merchantability, and fitness for a particular purpose.

C Corp Double Tax

A

R

M

- **Old law** – Income taxed at top rate of 35%. When income distributed to shareholder, the shareholder then paid tax on the dividend up to a top rate of 23.8%.
- Thus, owners of a ‘C corporation’ paid a combined total tax rate of 50.47% ($35\% + (65\% * 23.8\%)$)
- Sole proprietor, S corporation, partnership – Owners paid 40.8% (39.6% top rate plus a 1.2% phase out of itemized deduction for high earners)

C Corp Double Tax

A

R

M

- **New law** – Income taxed at top rate of 21%.
When income distributed to shareholder, the shareholder then pays tax on the dividend up to a top rate of 23.8%.
- Thus, owners of a ‘C corporation’ now pay a combined total tax rate of 39.8% ($21\% + (79\% * 23.8\%)$)
- Sole proprietor, S corporation, partnership –
Owners now pay a top rate of 37%

Business Deduction

A

R

M

- New 20% Business Deduction added for sole proprietors, S corporations, partnerships & trusts
- Reduces the effective top rate to 29.6% (new 37% top rate * 20% deduction)
- As such, non 'C corporations' will retain a ~10% rate advantage over C corporations

Business Deduction

A R M

- Section 199A – Very complex
 - Limitations
 - Thresholds
 - Phase-ins
 - Phase-outs
 - Definitions
- Applies to each business separately unless aggregated

Qualified Bus Income

A

R

M

The Sum of:

The Lesser of :

- 20% of “qualified business income” (QBI) or
- The Greater of:
 - 50% of the W-2 wages with respect to a business, or
 - 25% of the W-2 wages with respect to a business plus 2.5% of the unadjusted basis of all qualified property.

PLUS:

- 20% of qualified REIT dividends
- Qualified publicly traded partnership income

Qualified Trade or Business:

- Every trade or business is a qualified business other than:

1. The Trade or business of performing services as an employee, and
2. A specified service trade or business (SSTB)

Example:

- Brutus is an employee, but not an owner, in a qualified business.
- Brutus receives a salary of \$100,000 in 2018.
- Brutus is not permitted to a Section 199A deduction against the wage income, because Brutus is not engaged in a qualified business.

- Change from an employee to an independent contractor?
 - If someone was an employee, but then becomes an independent contractor while providing substantially the same services, it is presumed that they are still an employee for purposes of the Section 199A business deduction.
 - Presumption may be overcome if contractor can prove under Federal tax law, regulations, etc.

- Recharacterization only applies to *same* employer.
- If an employee leaves his/her employer and takes an independent contractor role with a NEW company, the presumption doesn't apply.

Qualified Trade or Business:

- Every trade or business is a qualified business other than:

1. The Trade or business of performing services as an employee, and
- 2. A specified service trade or business (SSTB)**

Service Limitation

A

R

M

- Health
- Law
- Accounting
- Actuarial science
- Performing arts
- Consulting
- Athletics
- Financial services
- Brokerage services including investing and investment management, trading, or dealing in securities, partnership interests, or commodities
- **Any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees**

***Architects & Engineers do qualify for deduction

- **Disqualified:** doctors, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other similar healthcare professionals who provide services directly to a patient.
- **Not disqualified:** people who provide services that may improve the health of the recipient, such as the operator of a health club or spa, or the research, testing, and sale of pharmaceuticals or medical devices.

- **Disqualified:** Lawyers, paralegals, legal arbitrators, and mediators.
- **Not disqualified:** Those that provide services not unique to law, like printing, stenography, or delivery services.

- **Disqualified:** Accountants, enrolled agents, return preparers, financial auditors, bookkeepers, and similar. You don't need to be a licensed CPA to fall victim to this rule.
- **Not disqualified:** No one, from what I can tell. We're all screwed.

- **Disqualified:** Actuaries and similar professionals.
- **Not disqualified:** Analysts, economists, mathematicians, and statisticians not engaged in analyzing or assessing the financial costs of risk or uncertainty of events.

- **Disqualified:** Actors, singers, musicians, entertainers, directors, and similar professionals who provide services that lead to the creation of performing arts.
- **Not disqualified:** Those who broadcast or disseminate video or audio to the public, and those who maintain or operate equipment or facilities used in the performing arts.

- **Disqualified:** those who provide professional advice and counsel to clients to assist in achieving goals and solving problems, including government lobbyists.
- **Not disqualified:** Salespeople and those who provide training or educational courses. This category also does not include any services ancillary to the sale of goods in a business that is NOT a SSTB (such as a building contractor) as long as there is no separate fee for the consulting services.

- **Disqualified:** Athletes, coaches, team managers.
- **Not disqualified:** Broadcasters or those who maintain or operate equipment used in an athletic event.

- **Disqualified:** Those who provide financial services to clients including managing wealth, developing retirement or transition plans, M&A advisory, valuation work. In other words, financial advisors, investment bankers, wealth planners, and retirement advisors.
- **Not disqualified:** Banking. Insurance producers, brokers and agents.

Brokerage Services

A R M

- **Disqualified:** A broker who arranges transactions between a buyer and a seller with respect to securities; i.e., a stock broker.
- **Not disqualified:** Real estate broker.

Invest. Management

A

R

M

- **Disqualified:** Those who receive fees for providing investing, asset management, or investment management services.
- **Not disqualified:** Real estate management.

- Any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees
 - Plumber?
 - Chef?
 - Photographer?

Catch-All

A R M

- Fortunately, the IRS chose to define the catch-all very narrowly!
- A trade or business in which a person receives fees, compensation, or other income for endorsing products or services,
- A trade or business in which a person licenses or receives fees, compensation, or other income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity, or
- Receiving fees, compensation, or other income for appearing at an event or on radio, television, or another media format.

Example:

- Urban is a well known chef and owns multiple restaurants
 - The restaurant income qualifies
- Urban also receives endorsement income for the use of his name on a line of cooking utensils
 - The endorsement income is disqualified

- What if business performs both qualified and disqualified services?
- De minimis exception
 - If gross receipts \$25 million or less, it will not be treated as a SSTB as long as less than 10% of gross receipts are disqualified services.
 - If gross receipts greater than \$25 million, the threshold percentage is reduced to 5%.

Planning idea – Sprinkle disqualified income to entities, but keep the % of income below the above thresholds

Service Limitation

A R M

- Service limitations don't apply if ***taxable income*** (*not AGI*) for the year is less than \$315,000 if you are married, and \$157,500 for all other taxpayers. Phases out from \$315,000 - \$415,000 for married and \$157,500 - \$207,500 for all others.

Qualified Bus Income

A

R

M

- Ordinary Income from a sole proprietorship, S corporation or partnership
- Does NOT include WAGES or GUARANTEED PAYMENTS
 - **Planning opportunity** – amend partnership agreement to try and eliminate guaranteed payments?
- Does NOT include short/long term capital gain/loss, dividend income or certain interest income

Assumptions

A

R

M

The examples to follow will assume the following:

- Married
- No other significant sources of income
- Standard deduction

Example S-Corp

A

R

M

- Non-service business / Assets not significant
- \$150,000 W-2 Wages
- \$500,000 Flow through ordinary K-1 Income
- **How much is the deduction?**

W-2 Limitation

A R M

The Sum of:

The **Lesser** of :

- 20% of “qualified business income” (QBI) or
- The Greater of:
 - 50% of the W-2 wages with respect to a business, or
 - 25% of the W-2 wages with respect to a business plus 2.5% of the unadjusted basis of all qualified property.

Example S-Corp

A

R

M

- Non-service business / Assets not significant
- \$150,000 W-2 Wages
- \$500,000 Flow through ordinary K-1 Income
- **Answer: Deduction would be lesser of \$100,000 (20% of \$500,000 K-1 income) or \$75,000 (50% of \$150,000)**

Example S-Corp

A

R

M

- Service business / Assets not significant
- \$125,000 W-2 Wages
- \$500,000 Flow through ordinary K-1 Income
- **How much is the deduction?**

Example S-Corp

A

R

M

- Service business / Assets not significant
- \$125,000 W-2 Wages
- \$500,000 Flow through ordinary K-1 Income
- **How much is the deduction? Zero since service business and taxable income over \$415,000**

Example S-Corp

A

R

M

- Service business / Assets not significant
- \$125,000 W-2 Wages
- \$100,000 Flow through ordinary K-1 Income
- **How much is the deduction?**

Example S-Corp

A

R

M

- Service business / Assets not significant
- \$125,000 W-2 Wages
- \$100,000 Flow through ordinary K-1 Income
- **How much is the deduction? \$20,000 (20% of \$100,000 K-1 income) since taxable income below \$315,000 threshold.**

Example Sole Prop.

A

R

M

- Service business / Assets not significant
- \$300,000 Schedule C Income
- No wages paid
- **How much is the deduction?**

Wage Limitation

A R M

- W-2 limitations don't apply if ***taxable income*** (*not AGI*) for the year is less than \$315,000 if you are married, and \$157,500 for all other taxpayers. Phases out from \$315,000 - \$415,000 for married and \$157,500 - \$207,500 for all others.
- Amounts will be indexed for inflation starting in 2019.
- Note: You determine taxable income without factoring in any potential 20% deduction

Example Sole Prop.

A

R

M

- Service business / Assets not significant
- \$300,000 Schedule C Income
- **How much is the deduction? Assuming married filing joint, the deduction would be \$60,000 (\$300,000 * 20%). W-2 limitations don't apply since taxable income under \$315,000.**

The deduction is equal to the sum of:

1. The Lesser of:

- The ‘combined qualified business income’ of the taxpayer, or
- 20% of the excess of taxable income over the sum of any net capital gain

2. PLUS the Lesser of:

- 20% of qualified cooperative dividends, or
- Taxable income less net capital gain

Capital Gain Limitation

A

R

M

- \$100,000 Qualified Business Income, \$200,000 Long-term capital gain, \$20,000 Wages, \$50,000 Itemized Deductions
- Thus, taxable income of \$270,000
- Business deduction is lesser of:
 - \$20,000 (20% of \$100,000 Business Income) or
 - **\$14,000** (20% * (\$270,000 - \$200,000 cap gain))
- **Planning Opportunity** – Roth conversion or other increase in ordinary income?

SE Income

- Business deduction does not reduce self-employment income.

Income:		
Self-employment Income	<u>300,000</u>	<u>300,000</u>
Total Income	<u>300,000</u>	<u>300,000</u>
Adjustments:		
Keogh & SEP Contributions	55,000	55,000
Self-employment Tax & Other Adjs	<u>11,978</u>	<u>11,978</u>
Total Adjustments	<u>66,978</u>	<u>66,978</u>
Adjusted Gross Income	233,022	233,022
Personal Exemptions	<u>0</u>	<u>0</u>
Total Itemized	0	0
Standard Deduction	24,000	24,000
Qualified Income Deduction	<u>60,000</u>	<u>0</u>
Total Deductions from AGI	<u>84,000</u>	<u>24,000</u>
Taxable Income	149,022	209,022
Regular Tax:		
Schedule or Table Tax	<u>24,664</u>	<u>38,744</u>
Appropriate Regular Tax	<u>24,664</u>	<u>38,744</u>
Self-employment Tax	23,956	23,956
High Income HI, Medicare & Other Tax	<u>243</u>	<u>243</u>
Total Federal Taxes	48,863	62,943

Spin-off/Cracking

A R M

- Disqualified Service entity
 - Spin-off business assets (employees, real estate, equipment, etc) into separate entity
 - Disqualified service entity pays rent to new entity, which would not be considered a disqualified service....

Spin-off/Cracking

A

R

M

RESTRUCTURING A BUSINESS TO GAIN A LARGER QBI DEDUCTION

PRE-STRATEGY	POST-STRATEGY
 <p>Radiology Practice Net Profit: \$900k QBI Deduction: \$0</p>	 <p>Radiology Practice Net Profit: \$380k QBI Deduction: \$0</p>  <p>Equipment Leasing Company Net Profit: \$100k QBI Deduction: \$20k</p>  <p>Employee Leasing Company Net Profit: \$300k QBI Deduction: \$60k</p>  <p>Medical Office Rental Company Net Profit: \$120k QBI Deduction: \$24k</p>
<p>Strategy Summary Total Net Profit: \$900k Total QBI Deduction: \$0</p>	<p>Strategy Summary Total Net Profit: \$900k Total QBI Deduction: \$104k</p>

© Michael Kitces, www.kitces.com

RELATIONSHIPS | built on results

An Independent Member of BKR International

www.armcpa.com

Spin-off/Cracking

A R M

- Proposed regulations address/ruin this strategy
- A SSTB includes any trade or business that provides 80% or more of its property or services to a SSTB as long as the two businesses share 50% or more common ownership.
- If a trade or business provides LESS than 80% of its property or services to a commonly controlled SSTB, only the portion provided to the SSTB is ineligible for the deduction.

Planning Opportunity

- CPA Firm (49%) and Financial Planning Firm (49%) purchase a building along with a third party (2%).
- Since no one owns 50% or more, the income would not be classified as coming from a SSTB.

Spin-off/Cracking

A

R

M

- One more way the regulations prevent cracking
- If non-SSTB is commonly controlled with a SSTB, shares expenses with the SSTB, and has gross receipts of 5% or less of the total combined gross receipts, it is treated as an SSTB, even it otherwise would not have been.

Example

- A dermatologist earns \$600,000 in 2018 from seeing patients. She also owns a business that sells skin care products with total revenue of \$20,000 and shares employees and office space.
- The skin care business is treated as a SSTB, because the businesses are commonly controlled, share expenses, and the revenue from the skin care line is less than 5% of the total combined receipts of \$31,000

Aggregation

A R M

- Section 199A required that the business deduction be determined on a business by business basis.
- Calculate the deduction for each business and then add together to arrive at deduction.
- Issue can arise when one entity has a lot of income and low W-2 wages, while a different entity has high wages and low income.

No Aggregation

A

R

M

	Scarlet	Gray
Income	1,000,000	0
W-2 Wages	0	500,000
QBI Deduction	0	0

Aggregation

A

R

M

	Scarlet	Gray	Aggregated
Income	1,000,000	0	1,000,000
W-2 Wages	0	500,000	500,000
QBI Deduction	0	0	200,000

Aggregation



- Aggregation under Section 199A can only be done when the following requirements are met:
- The same person or group of persons, directly or indirectly, own 50% or more of each business to be aggregated. There are attribution rules for these purposes. Thus, a taxpayer is treated as owning any interest owned by a spouse, child, grandchild, parent, etc.
- The "control test" is met for the "majority" of the tax year.
- The businesses share the same tax year.
- None of the businesses may be SSTBs.
- Continued on next slide.....

Aggregation

A R M

- The businesses to be aggregated must satisfy two of the following three factors:
- They must provide products or services that are the same or customarily offered together;
- They must share facilities or significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources; or
- The businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group.

Aggregation

A R M

- Aggregation is done at the owner level; thus, one owner of a business may elect to aggregate that business with another business while a second owner may not choose to do so.
- Aggregation is purely elective, and generally cannot be revoked once an election is made.
- If you elect to aggregate, you determine your share of QBI, W-2 wages, and property basis for the aggregated businesses before computing the deduction.
- **Aggregation doesn't always make sense.**

Allocation of Wages

A

R

M

- Professional Employer Organization (PEO) or other situations where employees are housed in separate entity.
- A business can take into account any W-2 wages paid by another business, provided that the W-2 wages were paid to "common law employees or officers" of the business for which the taxpayer is claiming the deduction.
- The allocation of W-2 wages will likely serve as a backup plan for businesses that aren't eligible to be aggregated under the regulations at Section 1.199A-4.

- Service and W-2 limitations don't apply if ***taxable income*** (*not AGI*) for the year is less than \$315,000 if you are married, and \$157,500 for all other taxpayers. Phases out from \$315,000 - \$415,000 for married and \$157,500 - \$207,500 for all others.
- **Planning Opportunity** - If in a SSTB and taxpayers' income is within the phase-out zone, try and find ways to reduce taxable income!

Phase-outs

A R M

	315k before QBI deduction	415k total phaseout
Income:		
Other Income	339,000	439,000
Total Income	339,000	439,000
Total Adjustments	0	0
Adjusted Gross Income	339,000	439,000
Personal Exemptions	0	0
Total Itemized	0	0
Standard Deduction	24,000	24,000
Qualified Income Deduction	63,000	0
Total Deductions from AGI	87,000	24,000
Taxable Income	252,000	415,000
Regular Tax:		
Schedule or Table Tax	49,059	96,629
Appropriate Regular Tax	49,059	96,629
Total Federal Taxes	49,059	96,629
Net Federal Tax Due	49,059	96,629
Resident State Tax	2,562	5,562
Net Resident State Tax Due	2,562	5,562
Total Net Tax Due	51,621	102,191

Increasing income by \$100k (and thus completely phasing-out of the business deduction) results in a tax increase of \$50,570...plus city tax!

Reduce Income

A

R

M

- Retirement or other reduction (H.S.A.)
- Hire employee
- Invest in equipment
- Donor advised fund for charitable bunching
- Pay kids (for work)
- Reduce portfolio income
- Work less?

Choice of entity?

A

R

M

- **What entity should I form?**
 - What type of business/service provided?
 - How much income do you anticipate making this year and in future years?

Comparison

- **S-Corp (SSTB or non-SSTB)**
 - \$150,000 Wages
 - \$150,000 Ordinary K-1 Income

\$30,000 deduction ($\$150,000 * 20\%$)

Vs.

- **Sole Proprietor (SSTB or non-SSTB)**
 - \$300,000 Schedule C Income

\$60,000 deduction ($\$300,000 * 20\%$)

Wage and service limitation don't apply due to income

Comparison

A

R

M

- **S-Corp (non SSTB)**
 - \$200,000 Wages
 - \$400,000 Ordinary K-1 Income

Lesser of \$80,000 deduction ($\$400,000 * 20\%$) or \$100,000 ($200,000 * 50\%$)

Vs.

- **Sole Proprietor (non SSTB)**
 - \$600,000 Schedule C Income
 - Zero wages

Lesser of \$120,000 deduction ($\$600,000 * 20\%$) or 0 ($0 * 50$).
Since income too high, W-2 limitations apply.

Comparison

A R M

- **S-Corp (SSTB)**
 - \$200,000 Wages
 - \$400,000 Ordinary K-1 Income

Zero since SSTB and over \$415,000 of taxable income, but you still get the payroll tax savings.

Vs.

- **Sole Proprietor (SSTB)**
 - \$600,000 Schedule C Income
 - Zero wages

Zero since SSTB and over \$415,000 of taxable income

Change entity

A R M

Convert non-salary paying Sole Proprietor, LLC or Partnership into S-Corp? Three questions:

1. Is the entity one that restricts the business owner from paying themselves a salary?
2. Is the business NOT a specified trade or service business?
3. Does the business owner have taxable income in excess of their threshold amount?

If you answer YES to all three, significant tax savings may exist.

File Separate?

A

R

M

- Husband (H) has \$175,000 of qualified business income from his sole proprietor law firm (no wages paid).
- Wife (W) is W-2 employee with wage of \$300,000.
- If H and W file a joint return, their \$475,000 joint income will exceed their \$315,000 - \$415,000 threshold amount and they will be subject to the service and W-2 limitation.
- In contrast, if they file separate returns, H would qualify for the deduction (example on next slide)

File Separate?

A

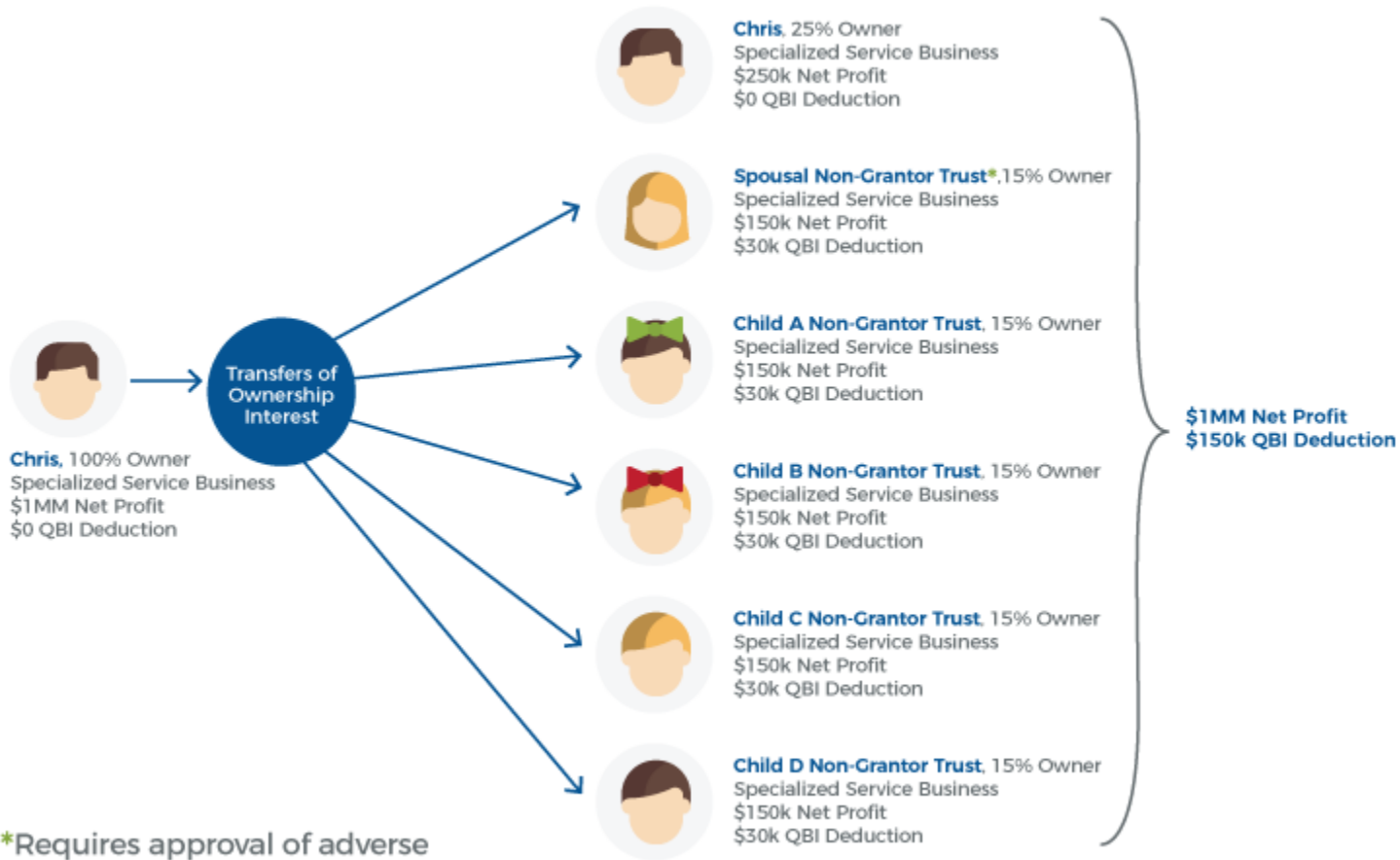
R

M

	Taxpayer	Spouse	Combined
Income:			
Wages	0	300,000	300,000
Self-employment Income	175,000	0	175,000
Total Income	175,000	300,000	475,000
Adjustments:			
Self-employment Tax & Other Adjs	10,304	0	10,304
Total Adjustments	10,304	0	10,304
Adjusted Gross Income	164,696	300,000	464,696
Personal Exemptions	0	0	0
Itemized Deductions:			
Taxes	5,000	5,000	10,000
Total Itemized	5,000	5,000	10,000
Standard Deduction	12,000	12,000	24,000
Qualified Income Deduction	35,000	0	0
Total Deductions from AGI	47,000	12,000	24,000
Taxable Income	117,696	288,000	440,696
Regular Tax:			
Schedule or Table Tax	22,537	76,490	105,623
Appropriate Regular Tax	22,537	76,490	105,623
Self-employment Tax	20,608	0	20,608
High Income HI, Medicare & Other Tax	330	1,575	1,905
Total Federal Taxes	43,475	78,065	128,136

Trusts

TRANSFERRING OWNERSHIP INTERESTS TO INCREASE QBI DEDUCTIONS



*Requires approval of adverse party for distributions.

© Michael Kitces, www.kitces.com

Loss carryforward

A R M

- If you have a net qualified business income loss, the loss is carried forward to future years to offset income.
- Passive loss carryovers from years before 2018 do not offset business income once utilized. However, passive losses generated in 2018 and after would offset business income.

Closing Thoughts

A R M

- Not simple...adds layers of complexity
- Many opportunities for significant tax savings
- Review returns and have discussions with clients and their CPA
- Will be difficult for self-preparers (much harder than the Ohio Business Deduction, which almost all self-preparers miss)

Questions?

A R M

William T. Vasil

CPA, CFP®, MAcc

Principal | Tax Advisors

📞 614.545.2049

📠 614.486.3400

✉️ wvasil@armcpa.com

A R M

RELATIONSHIPS | built on results

An Independent Member of BKR International



RELATIONSHIPS | built on results

An Independent Member of BKR International

www.armcpa.com