How to Qualify for - and Maximize - Your QBI Deduction
Pass-Through Entity Owners Need to Lower Taxable Income

Good news. The most sweeping tax code overhaul in decades, the Tax Cuts and Jobs Act of 2017 (TCJA), likely just reduced the tax on your business income.

It features dramatically reduced income tax rates for C Corporations (tax paying entities) via a new 21% flat rate. Yet most of the small businesses in the US are tax-conduits rather than C corps, which means rather than business income being taxed to the entity, it flows through to the owners' personal tax returns where owners pay taxes. Congress leveled the playing field by providing relief to these pass-through entities (S corps, partnerships, proprietorships, LLCs, etc.) comprising some 90% of businesses in America.

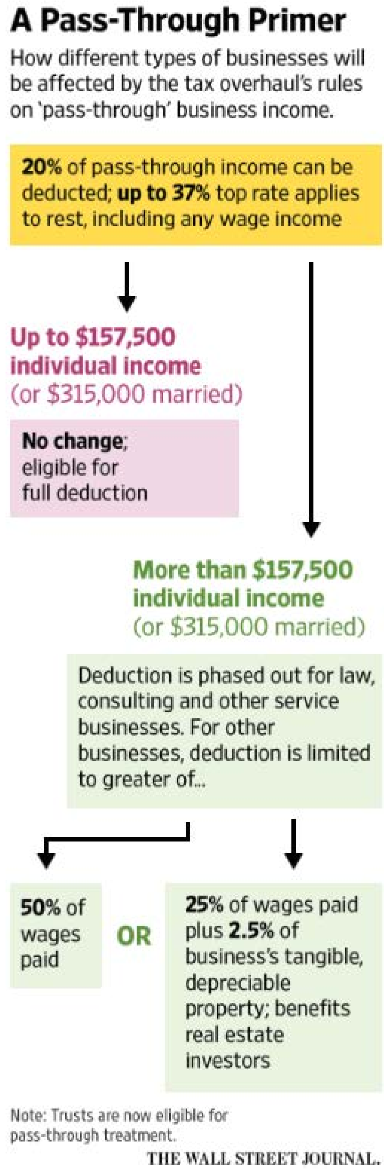
The new law's **Qualified Business Income** (QBI) deduction provides relief at the individual level via a **20% deduction** for pass-through business owners, subject to limitations. Most service providers (health, law, accounting, consulting, performing arts, etc.) need to keep their personal Form 1040 taxable income below a threshold to qualify.

These upper-income small business owners in a "specified service trade or business" do not qualify for the QBI deduction if their personal **taxable income** exceeds **$415,000** married filing jointly, and **$207,500** for other filers. The deduction is reduced with taxable income between $315,000 and $415,000 (joint return) and $157,500 and $207,500 (other filers). **The income cap does not apply to non-service businesses;** instead, less onerous wage and property tests apply when those owners' taxable income exceeds those same thresholds.

The value of the full QBI deduction is substantial for pass-through business owners, since it has them paying tax on only 80% of their qualified business income. Complexity arises once Form 1040 taxable income exceeds the thresholds or when multiple businesses are owned, given varying business classification and aggregation rules. Careful, integrated planning is needed to capitalize on the opportunity.

This letter will look at some **personal and business income reduction ideas** needed to help owners qualify for this tax largess. The following *Wall Street Journal* chart recaps the basic rules.

Let's look at a hypothetical case and see how the rules would apply: Roger is the owner of a financial services firm that generated $270,000 in net profits last year. In addition, Roger's wife Rachel, an engineer, makes $100,000 in salary. The couple's investments generated $40,000 of investment income in the past year. As a result, their combined adjusted gross income is $410,000 and they claim the new, expanded, $24,000 'standard deduction,' which reduces their **tentative taxable income** to **$386,000.**



Roger would normally be eligible for a $54,000 QBI deduction (20% of his $270,000 share of business income), but his business income is considered "specified service" income. And because the couple's tentative taxable income is $386,000, they are **71%** of the way through phase-out zone ($71,000 out of $100,000 over the $315,000 threshold for joint filers).

As a result, **they only keep 29%**, or $15,660, of their QBI deduction, which ultimately reduces their taxable income to $370,340 ($386,000 - $15,660). This illustrates that every penny counts, and business owners need to be cognizant of their complete tax posture, and proactive in seeking the deduction. Every dollar into the threshold range reduces the QBI deduction.

The QBI deduction is within reach for most. Every business should look to qualify for it to the extent it enhances after-tax economics without elevating risk or requiring inordinate effort. With the QBI deduction applied on the basis of an individual's taxable income, business owners should anticipate forthcoming liquidity events and the timing of other planning initiatives (Roth conversions), as they consider income reduction strategies at both the <u>personal</u> and <u>business</u> levels.

Personal income strategies

Increasing **retirement plan contributions** (either spouse) reduces taxable income and thus helps qualify for the QBI deduction. For the business owner, such an income deferral / contribution is noteworthy in light of the new tax regime, as it can **serve 'double duty'** by both:

- saving taxes at a marginal personal rate **in its own right** (reduces business profit flowing through to the individual return) and
- helping constrain Form 1040 taxable income in order to qualify for a (full or reduced) 20% QBI deduction.

Even owners of highly profitable tax-conduits (earnings well beyond the relevant thresholds) <u>may</u> be able to benefit from the QBI deduction via a larger retirement contribution available via an alternative plan design. Expanding deductible contributions is not hard; the challenge is in maximizing after-tax economics to the owner. Creative planning around plan design can slant contributions to owners in a variety of ways, but tax law is only so flexible and the final census can be a limiting reality.

Tax efficient investing is more important than ever as taxable consequences from an investment portfolio can, similarly, have duel implication. Portfolio-derived interest, dividends and capital gains are taxable in their own right **<u>and</u>**, as part of taxable income, they can preclude or limit a QBI deduction. Fortunately, we have proven tools and techniques to control investment-related tax noise, including strategic asset location, choice of vehicle (tax-free bonds, life insurance, annuities), and efficient tax loss harvesting.

That latter tactic, **tax-loss harvesting**, has long been a go-to tax planning option. By selling stocks with <u>unrealized</u> losses, taxpayers make those paper losses deductible in the year of sale. Here's some background on the technique.

An investment portfolio is generally comprised of multiple individual positions – each held at an (unrealized) gain, loss, or breakeven. With no tax ramification until a position is sold (<u>realized</u> gain or loss), it may make sense to '<u>harvest</u>' tax losses <u>by selling</u> one or more positions with unrealized losses, thereby making those 'paper' losses deductible in the year of sale. Such 'harvested' losses can offset realized capital gains for the year, and then offset up to $3,000 of ordinary income via an additional capital loss deduction. Net losses in excess of $3,000 are carried over to the next tax year. To maintain portfolio balance, a security with characteristics similar to the one sold for tax purposes is often purchased to replace the sold position. Tax law requires the replacement security be held for at least 30 days before selling it and reacquiring the original holding.

The QBI deduction is not an itemized deduction; it is more valuable than that, particularly as many / most opt for the recently expanded 'standard deduction' of $24,000 and $12,000, respectively, for joint and non-joint filers.

Grasping the new itemized deduction rules is important, particularly as it concerns charitable giving. Use of a donor-advised fund (DAF), for instance, can be useful to charitably inclined business owners expecting a significant capital gain or liquidity event. DAFs can provide an instant tax deduction (full market value of contribution) at funding, and the funds need not be immediately disbursed; they can sit until a charity is chosen and eventually funded.

Any non-itemizer over the age 70½ should consider gifting via **qualified charitable distribution** (QCD) to avoid having to take (into taxable income) required distributions from retirement plans. With the charity receiving the gift directly from an IRA, the gift is effectively made with pre-tax - rather than expensive post-tax - wealth.

Among other creative charitable strategies wealthier business owners consider are charitable remainder trusts (CRTs) and charitable lead trusts (CLTs).

CRTs provide an income stream from appreciated assets, in an efficient manner. Beyond helping the charity, the technique avoids capital gains on liquidation of the asset, provides the donor an annual income stream, removes an asset from the estate, and produces an up-front tax deduction for the remainder interest going to the charity at the trust's conclusion.

CLTs, in contrast, produce an income stream for the charity during the trust term, with the remaining assets eventually reverting to family members or other beneficiaries. Donors choose the term of the trust and the amount given annually to charity. CLTs have more utility in a low interest rate environment as the value of the annuity (tax deduction) is higher, while CRTs are favored in a higher rate environment.

Choice of tax **'filing status'** also warrants new attention. Instead of routinely defaulting to "married filing jointly," couples should consider a "married filing separately" status, as qualifying for the QBI deduction may outweigh other unfavorable tax implications of filing separately. As a couple's combined taxable income eclipses the $315,000 threshold, the QBI deduction begins phasing out until it is completely lost at $415,000. Separate filing may be indicated when one spouse's income would be eligible on its own to receive the QBI deduction (even at the lower threshold), while ineligible by virtue of the income threshold when combined with the spouse's income.

Contributions to flexible spending accounts (FSAs) and health savings accounts (HSAs) are excludible from taxable income reported by employers, while withdrawals for qualified medical expenses come out tax-free.

Business income strategies

In addition to personal strategies for controlling taxable income, several business income strategies should be considered.

One option is to distribute taxable income among several family members, perhaps by employing children (or other family members) of the business owner. Reduced taxable income to the business owner helps with the threshold tests, and redirection within the family may be less 'dilutive'. Of course payroll tax costs and kiddie tax implications (generally not an issue until earnings exceed $12,000) are considerations.

Shifting some business ownership to family members through non-grantor trusts will direct some of the business income to others, perhaps being taxed in a lower tax bracket. Trusts can aid tax planning while allowing for control and voting of the gifted shares. As Trusts have also been impact by tax reform, their terms must be carefully designed and understood. Ownership transfers must always be part of an integrated plan, which may entail reconciling conflicting objectives in structuring, owning, managing, and exiting the business.

As the QBI deduction does not include (offset) reasonable compensation paid to the taxpayer by the business, a natural friction can develop between W-2 income and reportable business earnings. **To the extent a reduced W-2 is taken by the owner, more business income remains to potentially benefit from the QBI deduction.** Competent tax advice is required to navigate the grey area defining the minimum W-2 income the IRS expects to be reported given the facts and circumstances.

The choice of regular vs. bonus depreciation method presents another lever for controlling reported taxable business income.

Cash basis taxpayers can often influence outcomes by moving income and deductions between years. This requires understanding tax rules governing the timing of income and expenses, including electronic payments (debit and credit cards), mailed checks, stacked deductions, deferred billing, and other options for managing year-end 'cutoffs.'

Entity selection is another possibility, but a host of both tax and nontax factors (capitalization, liability exposure, employee benefits, preferred accounting methods, succession plans, etc.) should be considered with the guidance of legal and tax counsel. From a business income tax perspective, the newly reduced (flat 21.0%) corporate income tax rate for C corporations (a **permanent change**) is more favorable than the top individual tax rate. Even an individual business owner qualifying for the full 20% QBI deduction still faces a best case marginal Federal rate of 29.6% (37% x 80%) on business earnings. However, other tax considerations beyond rate require a more nuanced evaluation, since C corp. shareholders must pay a second level of individual taxes on dividends received from the corporation and sacrifice flexibility in making distributions or in exiting the business.

Complicating the choice of entity is that the TCJA's **QBI deduction for tax conduit owners is temporary**; it's slated to expire after 2025. The tax code could always be changed by a future administration (in the face of massive fiscal deficits), a possibility that can neither be ignored nor quantified.

Summary

The new tax environment provides an **inflection point** for a fresh look at integrated business and individual planning goals. Tax reductions are freeing up capital to meet these objectives, including succession planning in concert with retirement timetable, employee retention, and protecting the business, the owner, his/her family and lifestyle.

While many of the benefits of the TCJA are set to sunset after 2025, the benefits of planning are more enduring. In all business planning, owners should consult with competent counsel for detailed tax and legal advice.

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