



# Planning for the Qualified Business Deduction

WHAT YOU NEED TO PLAN FOR BEFORE YEAR-END

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## Introduction: What makes the QBI Deduction so interesting?

- ▶ It's based on income, not deductions.
- ▶ It's a tactic intended to align tax rates between pass throughs and corporations, albeit in a rather clumsy manner.
- ▶ It effectively creates a new class of income.
- ▶ It leaves tons of room for effective planning.

# The big question is, will it work?

- ▶ Well, kind of.
- ▶ It will work for some, but not others.
- ▶ And, it may work better for , and not better for others.

# The key...

- ▶ Planning for clients right now, before year-end
- ▶ Many clients may face the law's limitations and restrictions.
- ▶ With swift intervention, comprehensive planning strategies may legitimately circumvent some or all of these issues.
- ▶ Now is the time to examine your client database and decide who may benefit from planning.

## Significant concerns:

- ▶ The taxable income limitation.
- ▶ Specified Service Trade or Business restrictions.
- ▶ W2 and Qualified Business Limitations.
- ▶ No QBI.
- ▶ Offshore Entity.

## Common illustrations based on Rico's client database.



## Taxable income limitation (disqualification) for a Specified Service Trade or Business:

- ▶ Example: Gordon, a single taxpayer, is the sole proprietor of a service-related business. Gordon is a tax practitioner.
- ▶ Gordon's taxable income for tax year 2018 flirts with the disqualification threshold of \$157,500.
- ▶ We have examined our client database and identified Gordon as a candidate for planning.
- ▶ And, we discover that Gordon may be able to legitimately lower his taxable income.
- ▶ Gordon should consider any discretionary expenditures he can make in 2018.

- ▶ If he needs equipment in his business, he should consider purchasing it before year end.
- ▶ Gordon should purchase his tax-prep supplies, folders, organizer envelopes in December instead of January.
- ▶ If Gordon has a charitable intent, 2018 is the year to consider giving to church or charity.
- ▶ And, if Gordon can legitimately defer recognizing income in 2018, he should. (Obviously, more difficult to accomplish legitimately)
  - ▶ Note: as a result, a new emphasis at audit could very well be accounting method. We may, in addition, need to review our client's accounting methods.

- ▶ Example: Myra, a single person LLC operating as a disregarded entity, performs specified services in the field of health. She is a chiropractor.
- ▶ A single taxpayer, her taxable income exceeds the \$157,500 consistently in prior years.
- ▶ If all things remain the same, Myra stands a good chance of disqualification from the deduction.
- ▶ Upon more careful analysis of her business operations, we discover that of Myra's gross sales, she receives 50 percent from chiropractic services, like spinal adjustments and manipulations, and 50 percent from retail sales, like vitamins and supplements, as well as ergonomic furniture and computer workstations.

- ▶ Myra must begin to craft her accounting system, so that she can accurately distinguish between those items of income and deduction that qualify her for the deduction, and those that do not.
- ▶ So, in 2018, if Myra's taxable income is over the threshold, it will only disqualify the *service-portion* of her business income. The *non-service* portion will qualify for the deduction.

# Taxpayer faces limitation or elimination of the deduction do to the W2 and QBP limits:



- ▶ Example: Chris is a software developer with significant taxable income—enough to set the limitation formula into motion.
- ▶ He pays various independent contractors to provide research and development services to his sole-proprietor business.
- ▶ He leases his office and IT equipment.
- ▶ As a result, Chris pays no wages, and owns no QBP.
- ▶ His dilemma is that he has significant net income from the business.
- ▶ What options does he have if any?

- ▶ If possible, Chris should consider employing some of his independent contractors.
- ▶ Chris should also consider purchasing his furniture and equipment.
- ▶ As an alternative, Chris can consider changing his business entity type to an S Corporation by making the proper election or elections.
- ▶ Especially If this action makes other business sense, and helps Chris advance his overall business goals.
- ▶ Now Chris can pay himself reasonable wages based on his study of similar wages paid in his industry, and since he now purchases rather than leases assets, he has effectively raised the bar on the limitation he faced regarding his QBI.

- ▶ Note: it will be important for Chris to weigh this decision in conjunction with the payroll tax savings he may enjoy with an S.
- ▶ This scenario can also work for a partnership going to an S.

## Taxpayer has no QBI:

- ▶ Example: Susan, a single taxpayer, owns a commercial rental property with gross rents of about \$80,000.
- ▶ Susan also incurs about \$80,000 in expenses on the rental, \$35,000 of which is mortgage interest on a \$750,000 mortgages.
- ▶ If Susan can make the \$35,000 in interest disappear, she could potentially generate \$35,000 in QBI, and recognize a \$7,000 199A deduction.
- ▶ If feasible, Susan should consider retiring the mortgage.

- ▶ As a result, she meets with her financial planner, and he carefully chooses individual securities from her portfolio that are long-term and either have significant basis, or, would result in a recognized loss if sold.
- ▶ She pays off the mortgage with the proceeds of securities sold and potentially pays tax on capital gains.
- ▶ The sale may prove advantageous as Susan *arbitrages* the tax rates.
- ▶ Susan may also consider deferring expenses such as repairs and decorating until next year.



- ▶ Example: Rico and George are equal partners in a business partnership that crafts, produces, and distributes artesian microbrews.
- ▶ After guaranteed payments, they have little or no QBI. (Remember, guaranteed payments do not generate QBI)
- ▶ Rico and George will reassess their partnership agreement and move more money from guaranteed payments to distributive shares.
- ▶ This simple shifting of income may provide a significant tax benefit.



## Offshore entity:



- ▶ If an otherwise qualified business is operating off shore, or subsidiaries are operating off shore, and main reason is tax concerns, it may be time to have a conversation about moving back to the US.