

Coming to Grips with Qualified Business Income

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it's

COMPLICATED!

**Coming to Grips With
Qualified Business Income**

Code §199A

Deduction for QBI

Qualified Business Income; Code §199A

Can deduct up to 20% of QBI

Applies to:

- Sole proprietorships
- Partnerships
- S corporation shareholders
- Estates and trusts

More precisely



- QBI deduction is 20% of lesser of:
 - Qualified business income
 - Taxable income – net capital gains (TI)
- Taxable income computed before QBI deduction

	Example 1	Example 2
Qualified business income	\$300,000	\$200,000
Taxable income	\$250,000	\$300,000
199A deduction	\$50,000	\$40,000



How to claim it

- 199A deduction does not reduce adjusted gross income
- You can claim it whether or not you itemize your deductions
- Expires after 2025

What is qualified business income?



- Determined (and limits applied) separately for each business
- “Items of income, gain, deduction, and loss to the extent such items are effectively connected with a trade or business within the United States”
- Likely translation for US business:
 - Bottom line Schedule C, F
 - Bottom line Schedule K-1
- Warning: Loss in year 1 carries over and reduces QBI in year 2

What about AGI deductions?



Adjusted Gross Income	23	Educator expenses	23			
	24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24			
	25	Health savings account deduction. Attach Form 8889	25			
	26	Moving expenses. Attach Form 3903	26			
	27	Deductible part of self-employment tax. Attach Schedule SE	27			
	28	Self-employed SEP, SIMPLE, and qualified plans	28			
	29	Self-employed health insurance deduction	29			
	30	Penalty on early withdrawal of savings	30			
	31a	Alimony paid b Recipient's SSN ► <input type="text"/> <input type="text"/> <input type="text"/>	31a			
	32	IRA deduction	32			
	33	Student loan interest deduction	33			
	34	Tuition and fees. Attach Form 8917	34			
	35	Domestic production activities deduction. Attach Form 8903	35			
	36	Add lines 23 through 35				36
	37	Subtract line 36 from line 22. This is your adjusted gross income ►				37

QBI doesn't include



- A. Reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business,
- B. Any guaranteed payment described in section 707(c) paid to a partner for services rendered with respect to the trade or business, and
- C. To the extent provided in regulations, any payment described in section 707(a) to a partner for services rendered with respect to the trade or business.

Example 1: S Corp



- Mary is an employee of her S Corporation
- S Corporation pays Mary W-2 wages of \$100,000
 - Reasonable compensation
 - She can use this as the basis of a retirement contribution
- S Corporation K-1 is \$200,000
 - This is QBI
 - Cannot use this as the basis of a retirement contribution

Example 2: Partnership



- Sue is a new partner at a law firm
- She receives a guaranteed payment of \$200,000 plus 4% of partnership profits
- Only the 4% of profits counts as QBI
- Both count as net earnings from self-employment/earned income

1	Ordinary business income (loss)
2	Net rental real estate income (loss)
3	Other net rental income (loss)
4	Guaranteed payments
5	Interest income
6a	Ordinary dividends
6b	Qualified dividends
7	Royalties
8	Net short-term capital gain (loss)
9a	Net long-term capital gain (loss)
9b	Collectibles (28%) gain (loss)
9c	Unrecaptured section 1250 gain
10	Net section 1231 gain (loss)
11	Other income (loss)
12	Section 179 deduction
13	Other deductions
14	Self-employment earnings (loss)



Example 3: Sole proprietor

- No guaranteed payments
- What reasonable compensation?

Two limits on QBI deduction



	Single	Married; Joint
Limits don't apply if taxable income less than	\$157,500	\$315,000
Limits fully phased in at	\$207,500	\$415,000
Taxable income computed before 199A deduction		

- Limit is boundary between 24%/32% tax brackets
- If fully phased in:
 - No QBI deduction for specified service trades or businesses
 - QBI deduction limited based on wages/depreciable assets

Specified service



- Health,
- Law,
- Accounting,
- Actuarial science,
- Performing arts,
- Consulting,
- Athletics,
- Financial services,
- Brokerage services,
- 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,
- Investing,
- Investment management,
- Trading,
- Dealing in securities, partnership interests, or commodities.

Effect of limit for specified service



- Doctor

- QBI: \$500,000
- TI: \$450,000
- 199A: \$0



- Restaurant chain owner

- QBI: \$500,000
- TI: \$450,000
- 199A: \$90,000



Have I got a plan for you

- Prospective client
 - Single emergency room doctor, sole proprietor
 - QBI = \$250,000 (20% = \$50,000)
 - Taxable income = \$210,000
 - No QBI deduction
- Add 401(k) plan - \$53,500
 - Taxable income before QBI = \$157,500
 - Full QBI deduction (\$31,500)





Wages depreciable assets

- If $TI > \$415,000 / \$207,500$ and not specific service, 199A deduction is lesser of:
 - 20% of QBI/TI
 - Greater of
 - 50% W-2 wages, or
 - 25% W-2 wages + 2.5% depreciable assets

W-2 wages



- Wages connected with QBI
 - Includes S Corporation shareholder wages
- For S Corporation or partnership
 - Based on allocable share of wage expense
- Must file W-2 timely (not later than 60 days after deadline)

Example: Not specified service



- Sole proprietorship with \$700,000 net income/year
- Taxable income = \$1,000,000; joint return
- Wages for employees = \$80,000
- 199A deduction is lesser of
 - \$140,000
 - \$40,000

Possible approach



- Incorporate; Elect S corporation status
- Pay owner salary of \$150,000 (basis of retirement plan)
- $QBI = \$700,000 - \$150,000 = \$550,000$
- $20\% QBI = \$110,000$
- $Total\ W-2\ wages = \$80,000 + \$150,000 = \$230,000$
- $50\% Wages = \$115,000$
- Owner gets \$110,000 QBI deduction

Depreciable property



- 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property
- Depreciable tangible property
 - Held by and available for use in the business at year end
 - Used during year to produce QBI
 - Depreciable period hasn't ended by end of year
- Depreciable period ends later of:
 - 10 years after placed in service in taxpayer's business or
 - Last day of last full year in recovery period

It takes a lot of property



- W-2 Wages = \$100,000
- Maximum QBI deduction = \$50,000
- Go to 25% + 2.5% formula
- Depreciable assets = \$1,000,000
- Maximum QBI deduction = \$50,000
- Partnership based on allocable share of depreciation deduction



Retirement plan deduction affects QBI



- Doctor: Sole proprietor, married
- Bottom line schedule C: \$340,000
- Itemized deductions \$40,000
- Net tax benefit of plan = \$10,560, 19.2% of \$55,000

	QBI without plan	QBI with plan
Bottom line schedule C	\$340,000	\$340,000
Retirement plan deduction	\$0	\$55,000
Taxable Income Before QBI	\$300,000	\$245,000
199A deduction	\$60,000	\$49,000
Final taxable income	\$240,000	\$196,000
Tax	\$46,179	\$35,619

You aren't just deferring tax on \$55,000

- You are also deferring tax on earnings on \$55,000
- The additional earnings from the deferral quickly make up for the rate differential



If that's a real concern, go with Roth

- But that won't reduce your taxable income (which you may need for QBI)

How do you deal with possibility that tax on distribution higher than deduction?

S Corporation dilemma



- S corporation W-2 to shareholder doesn't count as QBI
 - In fact, law allows IRS to count “reasonable compensation”
- But retirement plan compensation/deduction for S corporation shareholder is based on W-2
 - Pass-through dividends aren't compensation
- Guaranteed payments to partners aren't QBI

S Corporation Dilemma

Low
compensation

- Higher QBI deduction
- Lower FICA taxes

Higher
compensation

- Higher retirement contribution

Three kinds of owners



C Corporation

Taxable income over \$415K, \$207.5K

Phase-in territory

Taxable income below \$315K, \$157.5K

Not in specified service; lots of wages

Consider married filing separate



- John and Mary are both doctors; sole proprietors
 - Florida (no state income tax)
- John's Schedule C = \$200,000; \$50,000 solo k
- Mary's Schedule C = \$400,000, \$100,000 cash balance
- Standard deduction = \$24,000
- Taxable income = \$426,000
- No 199A deduction

John files separate return



- Schedule C \$200,000
- Solo k \$50,000
- Standard deduction \$12,000
- Taxable income \$138,000
- 199A deduction \$27,600
- Hint: Consider making \$18,500 deferrals Roth
 - Taxable income \$156,500
 - 199A deduction \$31,300

199A deduction effect on plan



- Doesn't affect plan compensation
 - Doesn't impact net earnings from self-employment
- But planning for it may have an impact
- Retirement plan affects 199A however:
 - Reduces taxable income
 - Likely reduces QBI



Thank you!



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