ADVISORY

Tax Planning Strategies: How to Maximize the Qualified Business Income Deduction?

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20% QBI Deduction for Pass-Through Income

The qualified business income (QBI) deduction is the centerpiece provision of the Tax Cuts and Jobs Act and applies from 2018 through 2025. Qualified business income is aggregated from a partnership, S corporation, limited liability company and sole proprietorship, and it is claimed on the individual tax return. Overall, you take 20% of QBI from a trade or business plus 20% of qualified real estate investment trust dividends and qualified publicly traded partnership income. There are three limitations associated with the deduction.

- **Specified Service Trades or Businesses**

The first limitation is designed to deter high-income taxpayers from trying to convert wages or other compensation for personal services into income that qualifies for the deduction. Trades or businesses with the performance of services in the following fields are subject to the limitation: health, law, consulting, athletics, financial or brokerage services or where the principal asset is the reputation of the employee or owner.

The QBI or Section 199A deduction doesn't apply to specified service trades or businesses (SSTB) when taxable income is above $426,600 for joint filers and $213,300 for other filers and is partially allowed when taxable income is between $326,600-426,600 for joint filers and between $163,300-213,300 for other filers (Tax Year 2020 levels).

- **Wages / Unadjusted Basis Immediately After Acquisition (UBIA)**

The QBI deduction cannot exceed the greater of:

a) 50% of taxpayer's allocable share of W-2 wages, OR

b) 25% of wages plus 2.5% of unadjusted basis (in depreciable property) immediately after acquisition

This limitation applies to all businesses when taxable income is above $426,600 for joint filers and $213,300 for other filers and is partially applied when taxable income is between $326,600-426,600 for joint filers and between $163,300-213,300 for other filers (Tax Year 2020 levels).

It's important to note that S corporations pay their owners W-2 wages, but sole proprietorships and partnerships do not. This can have an impact on how this QBI limitation is calculated.

- **Taxable Income Limitation**

The 20% QBI deduction is limited to 20% of taxable income without regard to net capital gain income. The 20% taxable income limit applies to the taxpayer's combined qualified business income from all businesses, whereas the prior two limits are applied at the activity or trade or business level.

Checklist to Maximize the QBI Deduction

Here are some planning tactics around the various limitations that may help you optimize your QBI deduction. This checklist is not exhaustive and there is some overlap between categories.

- If you have no or low qualified business income, see if there are opportunities to become a business owner, such as an employee becoming a consultant. Remember to take into account all considerations, such as a benefits package.

- If you're a specified service trade or business and subject to the phase-out, think about filing separately instead of jointly; or establishing a separate business, a separate entity or becoming a C corporation. Be careful though because there are some rules constraining these tactics.
- If you're subject to the wage / UBIA limits, think about hiring employees instead of contractors; increasing wages; purchasing assets; becoming an S corporation instead of a partnership or sole proprietorship. Remember to take into account all factors, such as any increased payroll tax and a benefits package provided to employees.
- If you're over the taxable Income threshold, think about deferring income and accelerating expenses, or making a retirement plan contribution to bring down taxable income in the current year.
- If you're subject to the 20% taxable income limit, think about trying to increase taxable income, such as taking on a second job.
- There are other planning strategies too, such as aggregating multiple business units to optimize the three components and limitations (QBI, Wages, UBIA).

Example – Reducing Taxable Income to Avoid Phase-out

Facts

- Married filing joint return
- Taxpayer has a job earning $250,000
- Spouse owns a business with $150,000 in income (a specified service trade or business)
- Other income of $60,000
- Taxable income above $421,400 threshold (TY19 threshold)

Results

- Column 1: No QBI deduction because taxpayer is above the threshold.
- Column 2: The spouse makes a maximum contribution to a SEP plan of $27,950. This reduces taxable income below the threshold and results in a QBI deduction of $5,366.
- Column 3: The combination of the SEP deduction and QBI deduction results in a total tax savings of over $11,000.

Advisory Services – Show Clients the Return on Investment

As tax professionals perform advisory services and provide their clients with tax planning strategies, it's important to point out the return on investment, so clients can see the value of the services. i.e. How much they're saving versus how much it costs them to do the extra work. Point out the fact that you're allowed to reduce their tax bill as long as you follow the law. The value of a good tax professional is to look for tax savings opportunities for their clients and QBI is a nice place to start!

Resources

- Form 8995-A instructions
- Recorded webinar – TCJA Tax Planning Strategies on QBI

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