Abbott, Stringham & Lynch

Tax Group

Tax Reform for Pass-Through Entities

Presented by:

Rob Trammell, CPA

February 7, 2018

Abbott, Stringham & Lynch

CERTIFIED PUBLIC ACCOUNTANTS & BUSINESS ADVISORS

Agenda

- Qualified Business Income Deduction (QBI)
- Qualified Business Income – What It Is and Is Not
- Income Phase Out Ranges
- Specified Service Business
- When Might It Be a Good Idea to Set Up As An Entity?
- Should You Consider Switching To A C-Corporation?

Qualified Business Income Deduction (QBI)

Section 199A Deduction, also known as Qualified Business Income Deduction (QBI) is available beginning in 2018 and expires in 2025 unless extended by Congress.

The Section 199A deduction gives owners of a pass-thru business a deduction equal to 20% of qualified business income.

Who Qualifies?

- Sole Proprietorships (Schedule C)
- Real Estate Investors (Schedule E)
- S-Corporations
- Partnerships
- Disregarded Entities (Single Member LLCs)
- Trust & Estate REITs and Qualified Cooperatives

You are not required to set up an entity to benefit from the Section 199A deduction, although you may want to. I will touch on this later in the presentation.

Qualified Business Income – What It Is and Is not

- Generally qualified business income is all domestic business income other than investment income (interest, dividends & capital gains).

- Qualified business income does not include the following:
  - C- Corporation dividend Income
  - Reasonable compensation to an S-Corporation Owner-Employee
  - Guaranteed Payments for Services in Partnership or LLC

- While the deduction is claimed for pass-thru business income, it will be claimed on the individual's personal tax return. This is a below the line deduction, meaning it is deducted from adjusted gross income to arrive at taxable income. The deduction is available to both itemizers and non-itemizers. The deduction does not apply to self-employment tax, it only applies for income tax purposes. However, there are restrictions.

Income Phase Out Ranges

- Married Filing Jointly: $315,000 completely phased out by $415,000 (adjusted for inflation)
- All other filing statuses: $157,500 completely phased out by $207,500 (adjusted for inflation)
- The effect of the phase out depends on whether the business income is:
  - From a "Specified service business"; or
  - From any other kind of business.

Specified Service Business

- A "specified service business" is defined as:
  - Traditional service professions such as physician, attorney, accountant, actuary and consultant
  - Performing artists who perform on stage or in a studio
  - Paid athletes
  - Anyone who works in the financial services or brokerage industry, or
  - Any trade or business where the principal asset is the reputation or skill of the owner.
- Not included in the traditional service profession are engineers and architects.

Specified Service Business (continued)

- The "specified service business" issue only comes up when your taxable income exceeds the above mentioned income thresholds. Once this occurs there is no deduction. For income in between the threshold amounts, a partial deduction is available.
  - For all other businesses that exceed the phase out levels for business income, their deduction is limited to the greater of:
  - 50% of the W2 wages with respect to the qualified trade or business, or
  - The sum of 25% of the W2 wages with respect to the qualified trade or business, plus
  - 2.5% of the unadjusted basis immediately after acquisition of all qualified property.
- For income in between the threshold amounts, a partial deduction is available based on the above W2 and depreciable asset limits calculations.

Specified Service Business (continued)

Let's look at some examples:

Example #1: (Full 20%)

- Thomas earns $100,000 in a law firm he operates as a sole proprietorship. His taxable income equals $100,000. He can use the Section 199A deduction, and the deduction equals $20,000.

Example #2: (Specified Service – over threshold)

- Martha earns $500,000 as surgeon working as a partner in a surgical center and her family's taxable income equals $500,000. She cannot use the Section 199A deduction.

Example #3: (W2 Calculation)

- Nancy, who is single, owns an S-corporation. Her S corporation pays $100,000 in W2 wages and earns $400,000 in net qualified business income. Because she is considered a "high earner" by exceeding the income limits, her deduction is limited to 50% of the W2 wages ($50,000) which is less than 20% of $400,000.

Specified Service Business (continued)

Example #4: (Specified Service – over threshold)

- Based on example #3, if Nancy operates as a specified service trade instead, she would completely phase out of the section 199A deduction by exceeding the income limit of $207,500.

Example #5: (W2/asset calculation)

- Sarah is a real estate investor who has net rental income of $500,000 on her Schedule E. She does not pay any wages (no W2) and her unadjusted basis in the properties is $800,000 (purchase price). The calculation is as follows:
  - 20% x $500,000 = $100,000 (straight calculation)
  - 50% of $0 = $0 (W2 calculation)
  - 2.5% of $800,000 = $20,000 (depreciable asset limit calculation)
- Sarah's Section 199A is limited to the lessor of $100,000 as compared to the greater of $0 (W2 wages) and $20,000 (2.5% x depreciable assets). Her deduction is $20,000.

Specified Service Business (continued)

Example #6: (Partial Deduction)

- Joyce is single and a sole proprietor with net qualifying business income of $100,000 and *taxable* income (from her 1040 and before Section 199A deduction) of $177,500. Joyce's deduction is partially phased out because her total income is $20,000 over the initial range ($157,500). The total phase out range is $50,000 ($157,500 - $207,500). The phase out is calculated as 40% ($20,000/$50,000) of her initial deduction of $20,000 ($100,000 x 20%). The phase out is $8,000 ($20,000 x 40%), therefore her Section 199A deduction is $12,000 ($20,000 - $8,000).

- Please keep in mind that the Section 199A deduction amount is not the actual tax savings amounts. To determine the actual reduction in tax associated with the deduction, the taxpayer will need to multiply their Section 199A deduction amount by their marginal or top tax rate.

When Might It Be a Good Idea to Set Up As An Entity?

- You are a high earner, not in the specified service business
- You currently file as a Schedule C, operate as a single member LLC, or do business as a proprietor
- You do not have payroll or depreciable property
- In this situation you could find yourself with a zero deduction unless your create an S-corporation.

When Might It Be a Good Idea to Set Up As An Entity? (continued)

Creating the Section 199A Deduction

IRC Sections 199A(a), 199A(b).

With $370,000 in taxable income, $400,000 of qualified business income, and no wages or property, your Section 199A deduction is zero. With $100,000 of wages, your results are

Step 1, find the lesser of	Amounts
20% of $300,000 qualified business income	$60,000
50% of S corporation's total wages of $100,000	$50,000

Step 2, find the lesser of	Amounts
Step 1 result	$50,000
20% of $370,000 in taxable income	$74,000

$17,500 Tax Savings from Newly Created Section 199A Deduction ($50,000 x 35% Tax Bracket)—Thank You, S Corporation

BRADFORD TAX INSTITUTE

When Might It Be a Good Idea to Set Up As An Entity? (continued)

- Even if you are not a high income earner, there are benefits to creating an S-corporation. Let's do the math on a hypothetical situation between an S-corporation and sole proprietorship.

The Equation (One Look)

	S Corporation	Proprietorship
Net income (without wages)	$120,000	$120,000
Wages	-50,000	
Qualified business income	$70,000	$120,000
Tentative Section 199A deduction	$14,000	$24,000
Single taxpayer marginal tax rate	24%	24%
Tax savings from 199A deduction	**$3,360**	**$5,760**
Payroll taxes (FICA, Medicare, unemployment) 15.3% x $50,000 = $7,650 + $500 = $8,150	$8,150	
Self-employment taxes (15.3% x 92.35% = 14.13%)		$16,956
Tax savings, employment taxes ($16,956 - $8,150)	**$8,806**	
Total tax savings (big picture)	**$12,166**	**$5,760**
Winner (S corporation)	$6,406	

BRADFORD TAX INSTITUTE

8

When Might It Be a Good Idea to Set Up As An Entity? (continued)

Section 199A Application Flowchart - Spidell

Does the taxpayer have business income?	No →	No deduction
↓ Yes		
Is overall business income positive?	No →	No deduction
↓ Yes		
Is the taxpayer's taxable income below the top of the phase-out range?	Yes →	T/P can take deduction
↓ No		
The taxpayer's income is over top of phase-out range.		
↓ Continued		
Is the business a service business?	Yes →	No deduction
↓ No		
The taxpayer can take deduction.		

Abbott, Stringham & Lynch
CERTIFIED PUBLIC ACCOUNTANTS & BUSINESS ADVISORS

Allinial GLOBAL™
An association of legally independent firms

Should You Consider Switching to a C-Corporation?

- In terms of just exploring this option based on the potential tax savings, the answer is no. For most, a C-corporation doesn't make sense after you add in the capital gain tax on the dividends.

Tax Rate Comparison: S vs. C Corporation

S Corp.	C Corp.	C Corp. Rate on 1120	Cap. Gains on 1040	79% Gains effective %	79% of 3.8% NIIT
10%	21%	21%	0%		
12%	21%	21%	0%		
22%	32.85%	21%	15%	11.85%	
24%	35.85%	21%	15%	11.85%	3.002%
34%	35.85%	21%	15%	11.85%	3.002%
35%	35.85%	21%	15%	11.85%	3.002%
37%	39.80%	21%	20%	15.5%	3.002%

Notes. The break points above are not exact, because the 2018 capital gains rates do not apply by brackets as they did in 2017. If the S corporation were in the in-favor group, the S corporation rates would be 20% lower in the lower brackets and with proper wages and/or property in the upper brackets, too (e.g., the 10% rate would be 8%).

BRADFORD TAX INSTITUTE

26

Tax Reform for Pass-Through Entities

- Questions?