



Tax Cuts and Jobs Act: Planning for the new qualified business income deduction

The new qualified business income deduction provision in the Tax Cuts and Jobs Act (TCJA) is one that has a greater impact and has created the most confusion. It was included in the tax bill as a way to level the playing field for pass-through entities and sole proprietors versus the major tax cuts implemented for C corporations.



Listed below are the basic rules for the 20% deduction for qualified business income (also referred to as the Section 199A deduction):

- A qualified business generally means any business except those “specified service businesses” or income as an employee, guaranteed payments or personal interest, dividends, and capital gains for the individual.
 - The specified service businesses are in the fields of health, law, accounting, consulting, brokerage services, financial services, and others. Remember that architects and engineers were excluded from specified service businesses.
 - The deduction is available to sole proprietors and owners of pass-through entities such as S-Corps, LLCs, and partnerships.
 - The deduction is subject to limitation based on the taxpayer’s income and the type of business.
 - The deduction is taken “below the line.” In other words, it reduces your taxable income, but not your adjusted gross income and can be taken regardless of whether you itemize deductions or not.
 - Dollar threshold limitations: To get the full benefit of the 20% deduction (i.e., not be subject to further wage and capital limitations), taxable income must be no greater than the threshold:
 - Married Filing Jointly (MFJ) = \$315,000 (phases-out through \$415,000)
 - Single or Married Filing Separately (MFS) = \$157,500 (phases out through \$207,500)
 - If the pass-through entity owner is below the dollar threshold, it doesn’t matter if the business is a qualified trade or business or a specified service business—it gets the §199A deduction.
 - If over the dollar threshold:
 - Specified service business—gets no §199A deduction; and
 - Qualified trade or business—gets the §199A deduction, but subject to the wage and capital limitation.
 - The deduction is **the lesser of**:
 - 20% of the taxpayer’s qualified trade or business income; or
 - A wage and capital limitation, which is the greater of 50% of the W-2 wages of the qualified trade or business; or 25% of the W-2 wages of the qualified trade or business plus 2.5% of the unadjusted basis of all qualified property
- Plus:**
- 20% of REIT dividends and distributions from publicly traded partnerships.

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W-2 wage limitations

The W-2 limitations effectively limit the deduction if the business does not employ a substantial number of people relative to the size of the business, referred to as the “W-2 wage limit,” or invest in a substantial amount of property under the “wage-and-property limit.” Businesses that rely primarily on the efforts of their owners (specified service business) or those with a limited amount of employee or capital investments, will struggle to take advantage of the new qualified business income deduction.

And finally, there is an overall limitation on the deduction. It is the lesser of:

- Combined qualified business income, or;
- 20% of the excess (if any) of taxable income minus the sum of any net capital gain plus any qualified cooperative dividends

The total amount cannot exceed the taxpayer’s taxable income (minus the taxpayer’s net capital gain) for the tax year.



Here are some strategies to optimize the availability of the pass-through deduction:

- If some portion of the qualifying business income comes from a “specified service business” could you consider spinning off portions of the business (i.e., separating the specified service business portion from the other qualified trade or business portion) in order to maximize the use of the pass-through deduction?
- Consider operating as a real estate investment trust (REIT). REITs do especially well. There is only one level of tax. The shareholders are entitled to a 20% qualified business income deduction for ordinary distributions with no W-2/basis limitation. However, REIT compliance and maintenance rules are onerous.
- Consider operating as a publicly traded partnership (PTP). PTPs are not subject to the W-2 wage and qualified property cap.
- For S corporations, it may be beneficial to take advantage of reasonable compensation. For the new pass-through deduction rules, you would want the 50% of wages limitation to be higher.
- Consider rearranging an employer-employee relationship to one in which there is a partnership with the original partnership under a partnership agreement in which the individual’s income from the partnership could be eligible for the Section 199A deduction.
- Consider “multiplying” the \$157,500 per person threshold by gifting business ownership interests to children or non-grantor trusts.
- For partners, consider switching from guaranteed payments (which don’t qualify) to preferred returns (which do qualify).
- Consider increasing the W-2 limit by switching from 1099 independent contractors to W-2 employees. However, also consider that you may have to provide W-2 employees fringe benefits as well.
- Consider managing taxable income so it is below the phase-out thresholds in order to qualify for the 199A deduction.
- Consider increasing a pension contribution to reduce taxable income. If the taxpayer is over the income limit, salary could be reduced and a mandatory pension contribution, such as a contribution to a cash balance plan, could be increased. No part of the pension contribution would be included in income, so the deduction could apply.
- Make tax-deductible qualified retirement plan contributions to reduce an individual’s taxable income in order to qualify for the 199A deduction.

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Any of these strategies should be considered with a good dose of caution. There is still a lack of clarity and guidance into the definitions and how these deduction rules are to be applied.

The IRS has been directed to prescribe regulations that are necessary to carry out the purpose of the deduction. However, we may not see these regulations until later this year or next year. Also, remember that this provision is expected to sunset in 2025, unless extended or made permanent by a future administration.

For more information, please contact your Key Private Bank Advisor.

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