Planning for the Qualified Business Income (Section 199A) Deduction

As a business owner, you already know that one of the provisions of the Tax Cuts and Jobs Act of 2017 reduced the corporate income tax rate to a flat 21percent for C corporations. However, according to the U.S. Small Business Administration, 98.5 percent of businesses are pass-through entities (i.e., S corporations, limited liability companies, partnerships and sole proprietorships)* where business income is taxed at potentially higher personal income tax rates. As a compromise to pass-through owners, a new Section 199A of the Internal Revenue Code was established that provides a 20 percent income tax deduction on "qualified business income ("QBI")" subject to certain limitations.

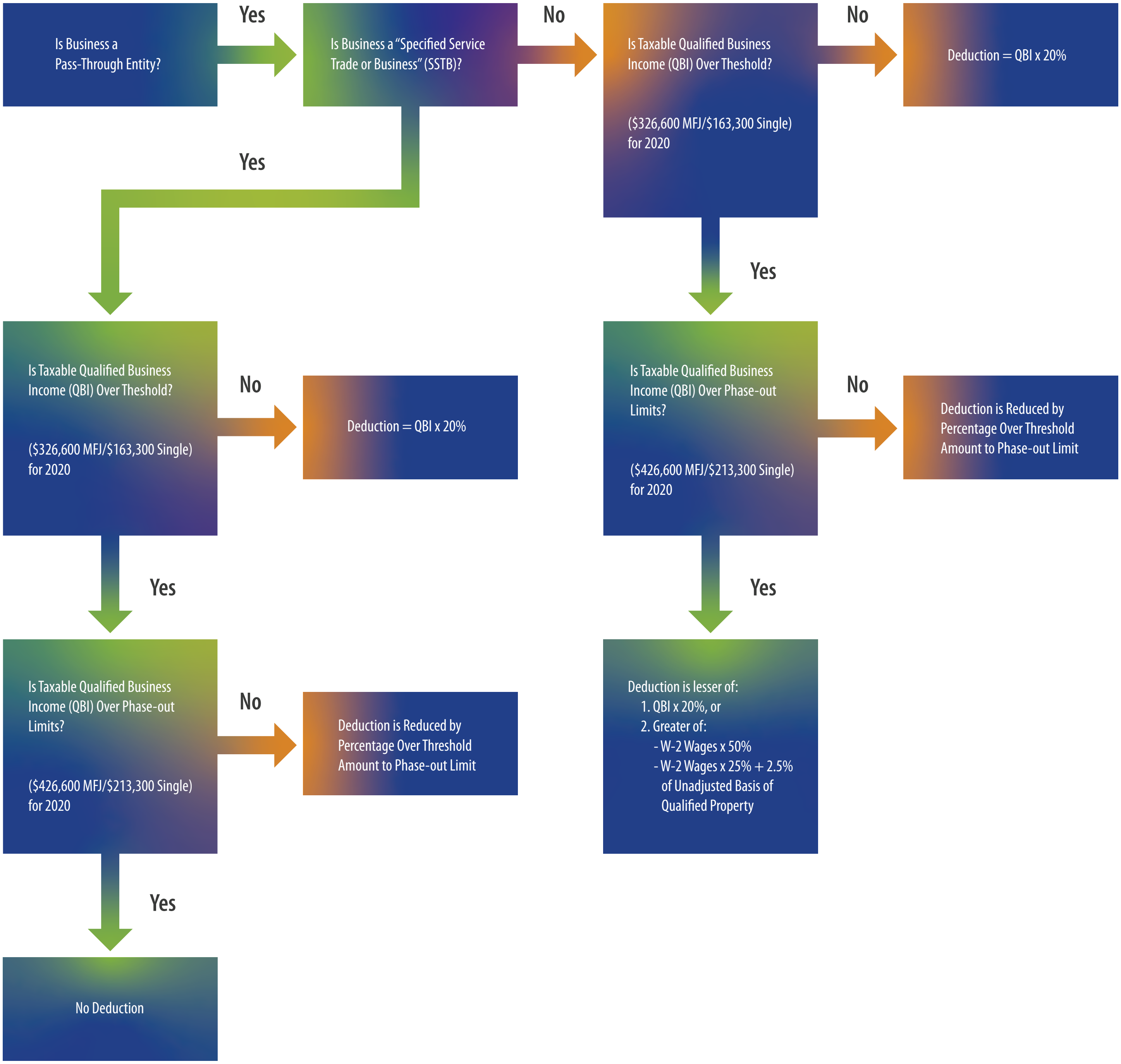
Additional Limitations

A pass-through business that is a "specified service trade or business (SSTB)" is subject to even more limitations. SSTBs include any business involved in the performance of the following services: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing or investment management, and trading or dealing in securities, partnership interests, or commodities. Interestingly, SSTBs do not include businesses providing architectural or engineering services.

Section 199A

Section 199A is very complex. You must consult with your own tax and legal advisors to assess your individual situation. The flowchart on page 2 is a simplistic summary of the deduction. QBI is relative to adjusted gross income ("AGI") levels and dependent upon tax filing status (i.e., married, filing jointly ["MFJ"] or single).

Section 199A (continued)



As you can see, there are three main factors to consider when determining the deduction: (1) the amount of qualified business income relative to AGI and tax filing status; (2) the amount of W-2 wages paid to employees; and (3) the unadjusted basis value of qualified property. SSTB owners, however, cannot rely upon the second and third factors.

What is obvious from the chart, notwithstanding the complexity of the law, is that exceeding the phase-out limitations would limit or eliminate the deduction, particularly for SSTBs. The planning opportunity is, therefore, to control taxable income. One of the best ways to reduce taxable business income is the installation of, or maximization of existing, qualified retirement plans because contributions into a plan are tax-deductible.

Here's an Example:

Mary is a CPA with her own practice and has QBI of $400,000. She is also married and files a joint tax return with her spouse who earns $100,000. According to the law, her business is an SSTB that may qualify for the Section 199A deduction. Mary currently has a SEP to which she contributes the maximum. The SEP contribution is tax-deductible, reducing her taxable business income. Even with the SEP, however, AGI is still above the phaseout threshold of $426,600. However, if Mary implements a qualified defined benefit plan, the contribution to the plan reduces her income below the threshold which makes her eligible for the 20 percent deduction and reduces her income tax burden. The strategy may also reduce the federal income tax bracket from 35 percent to 24 percent. In the end Mary and her spouse save a substantial amount of taxes and increase their retirement savings at the same time.

	Profit Sharing Plan	Defined Benefit Plan with Life Insurance
Mary's Gross QBI	$400,000	$400,000
Spouse's Income	$100,000	$100,000
SEP Contribution	$57,000	N/A
Defined Benefit Contribution	N/A	$150,156
Taxable QBI	$343,000	$249,844
Combined AGI	$443,000	$349,844
199A Deduction	$0	$38,354
Taxable Income	$443,000	$311,490
Tax	$155,050	$74,758
Tax Savings		$80,292

You'll notice that the combined AGI of Mary and her spouse is $349,844, which is above the threshold but within the phaseout amount. Accordingly, the QBI deduction is reduced.

Calculation of 199A Deduction When AGI in Phaseout Range	
Determine Amount Over Threshold	$349,844 - $326,600 = $23,244
Determine Percentage Until Phaseout	23,244/100,000 = 0.23244
Determine Percentage of Deduction Allowed	1.0 - 0.23244 = 0.76756
Determine QBI Deduction of No Phaseout	$249,844 x 20% = $49,968.80
Apply Reduction	$49,968.80 x 0.76756 = $38,354

The foregoing is an overly simplified example, but it demonstrates the power of a planning strategy that not only helps to save on income taxes today, but also helps to build a retirement nest egg for the future.

For more information and to discuss the appropriate strategies for your business and unique circumstances, please contact your Security Mutual life insurance advisor.

[*]“Frequently Asked Questions About Small Business,” U.S. Small Business Administration Office of Advocacy, September 2019, p. 3, <https://cdn.advocacy.sba.gov/wp-content/uploads/2019/09/24153946/Frequently-Asked-Questions-Small-Business-2019-1.pdf> (accessed February 16, 2020).

The applicability of any strategy discussed is dependent upon your individual facts and circumstances. Results will vary. Products and services discussed may not be appropriate for all clients. Your needs, objectives and financial circumstances may be different and must be reviewed and analyzed independently.

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