Taxation - Income, Estate, and Gift

IRC §199A pass-thru business deduction: Applying the 28.57% magical W-2 formula.

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Much of estate planning since 2020 has focused on planning to maximize the Internal Revenue Code (IRC) Section 199A pass-through business deduction. This deduction allows certain taxpayers to deduct 20% of their qualified business income (QBI). In fact, a basic understanding of these new rules is a must for any estate planner going forward.

Not every taxpayer can receive this deduction, so estate planners have a huge opportunity to exploit this statute by educating themselves with the details of the statute.

Dollar ceilings and phase-outs

For a married couple with taxable income of no more than $340,100 (in 2022) and for an unmarried individual with taxable income of no more than $170,050 (in 2022), there are minimal rules and the 20% federal income tax deduction is available.

There is a phase-out of the deduction from $340,100 to $440,100 for married taxpayers, and from $170,050 to $220,050 for unmarried taxpayers. These figures are for taxable income, not just based on QBI.

Specified service, trade or business rules

For specified services, trades or businesses, unfortunately no IRC §199A deduction is available for owners whose taxable income exceeds the dollar amounts noted above. A specified service, trade or business means any trade or business involving the performance of services in the fields of: Health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, including investing and investment management, trading or dealing in securities, partnership interests or commodities, and any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners.

Non-specified service, trade or business wage and capital tests

For businesses that are not considered a specified service trade or business, an IRC §199A deduction is available for owners whose taxable income exceeds the dollar amounts outlined above. However, the deduction is limited to the greater of:

(a) 50% of W-2 wages, or

(b) 25% of W-2 wages, plus 2.5% of qualified property (certain depreciable property such as buildings and equipment).

Non-specified service, trade or business: Choice of entity example

Assume $1,000,000 of QBI for this tax year and that the business has no qualified property.

Let's compare three choices of business entity: Sole proprietorship, partnership and S corporation.

- **SOLE PROPRIETORSHIP:** $1,000,000 QBI; $0 W-2 wages. Therefore, $0 QBI deduction.
- **PARTNERSHIP:** $1,000,000 QBI; $0 W-2 wages. Therefore, $0 QBI deduction.
- **S CORPORATION:** Assume $200,000 wages. Therefore, $800,000 QBI. Does this mean you get a $160,000 QBI deduction (calculated as 20% of $800,000)? Unfortunately, no.

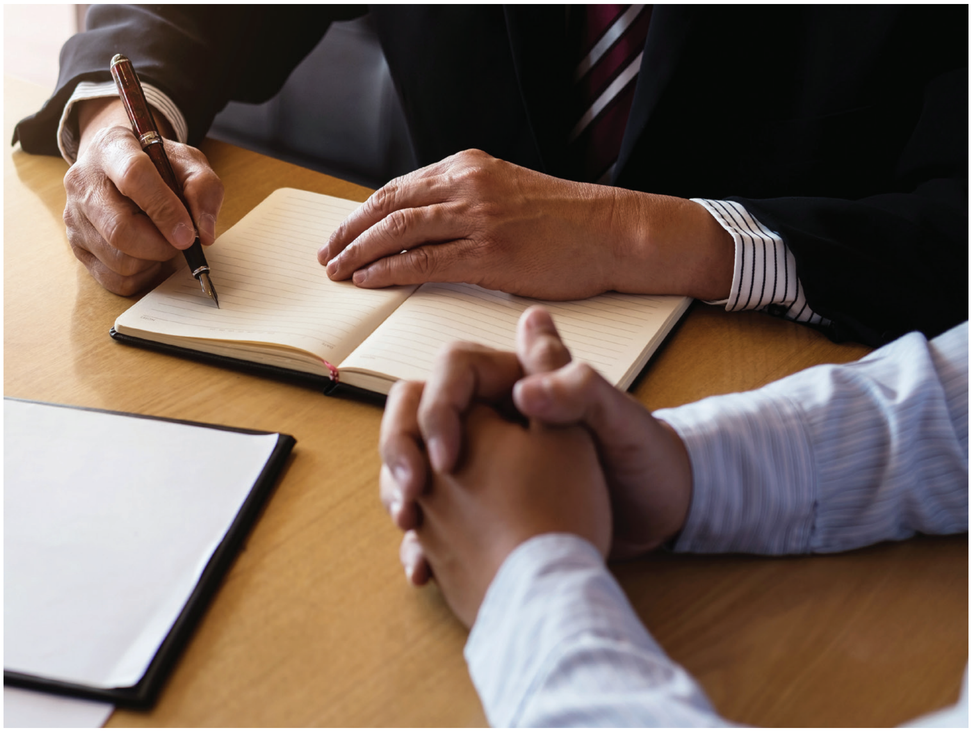
If we apply the W-2 wage test which is 50% of $200,000, the deduction is limited to $100,000 which is still a better result than getting no deduction if using a sole proprietorship or partnership.

Applying the magical 28.57% W-2 formula

The ideal sweet spot for percentage of W-2 wages versus overall business income is 28.57%.

(To be more specific, 28.5714285714286% which is computed by either

(a) dividing 3.5 into 100 or by
(b) dividing 2 into 7 and multiplying by 100.)



Looking at the earlier example, assume that we increase the W-2 wages, using the magical W-2 formula, to 28.57% of the $1,000,000. Therefore, the W-2 wages are $285,700 and the QBI is reduced to $714,300.

$285,700 x 50% = $142,850

$714,300 x 20% = $142,860

Therefore, after applying the magical 28.57% W-2 formula and increasing W-2 wages, we have discovered the sweet spot to maximize the IRC §199A deduction at $142,850!

Using additional taxpayers to improve this result

Although this 28.57% magical W-2 formula will be ideal for many business owners who exceed the $340,100 ($440,100 phase-out) and $170,050 ($220,050 phase-out) ceilings, with some additional planning, in many cases superior results can be achieved to even further exploit the new IRC §199A rules. This even works for specified services, trades or businesses!

This extra planning involves the use of additional taxpayers as co-owners of the business.

For example, consider transferring part of the business to a separate non-grantor trust for the benefit of each child and grandchild of the business owner, and also a separate non-grantor trust for the benefit of the business owner's spouse. (The non-grantor trust for the benefit of the business owner's spouse will require an adverse party to approve distributions to the spouse in order to avoid grantor trust status.)

Each individual non-grantor trust has a separate ability to stay within the $170,050 taxable income ceiling. Therefore, this works whether the business is a specified service, trade or business or a non-specified service, trade or business.

Back to the $1,000,000 QBI example

Using the same numerical example as above, again assume $1,000,000 of QBI for this tax year and that the business has no qualified property.

And again, note that this time it doesn't matter whether the business is a specified service, trade or business or a non-specified service, trade or business.

Further assume that the business is a limited liability company taxed as a partnership.

(This example will also work with S corporation taxation, except that since the S corporation taxation will require reasonable compensation that will reduce the QBI below $1,000,000 (maybe to $850,000, for example, which would reduce the QBI to $850,000), let's keep this simpler and assume the $1,000,000 QBI using partnership taxation.)

Assume that the client keeps 30% of the business and has no other income from other assets. Assume that the client gifts 10% of the business to a non-grantor trust for the client's spouse and 10% each to individual non-grantor trusts for each of the client's three children and three grandchildren.

- Client: $300,000 QBI
- Non-grantor trust for client's spouse: $100,000 QBI
- Non-grantor trust for child #1: $100,000 QBI
- Non-grantor trust for child #2: $100,000 QBI
- Non-grantor trust for child #3: $100,000 QBI
- Non-grantor trust for grandchild #1: $100,000 QBI
- Non-grantor trust for grandchild #2: $100,000 QBI
- Non-grantor trust for grandchild #3: $100,000 QBI

Therefore, since all business owners qualify for the IRC §199A pass-through business deduction, there is a full $200,000 deduction which is an even better result than with the S corporation and the magical 28.57% W-2 formula.

But each client is different, since this example required the client to give up a lot of income to make it work out like this.

In many cases, with a non-specified service, trade or business (but not with a specified service, trade or business), the client may choose to instead change the taxation to that of an S corporation and use the magical W-2 formula with 28.57% of W-2 wages, which reduces the cumulative IRC §199A pass-through business deduction well below what is achieved in the example above and adds self-employment taxes, but doesn't require so many trusts.

Again, each client is different. There is rarely only one option.

The bottom line is that there are multiple options that can now be used to help clients by exploiting these new rules.

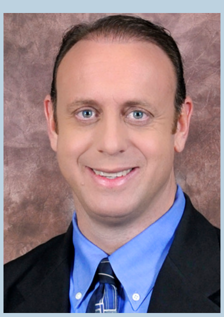
Using the lower tax brackets of the children and grandchildren

Taking this even further, depending upon the family (since each family has children and grandchildren with varying needs, abilities and trustworthiness), part or all of the income can be distributed to the children and grandchildren each year.

Assuming that the children and grandchildren are in lower income tax brackets than that of the trust, an additional arbitrage can be obtained by doing this. The additional income tax savings via this arbitrage can be huge, especially over time since this can be done every year, if desired.

And taking this even further, for the right family, these beneficiaries can pay tax on the distribution in their lower income tax brackets, use the 20% pass-through business deduction, and maybe keep part of the money and gift part of the money back to the client (recognizing the client's much smaller cash flow as a result of the gifting).

Once again, each client is different. Advisors should use these ideas as appropriate for specific clients, and clients should consult with their advisors to determine which method works best for their situation.



Steven J. Oshins, Esq., AEP® (Distinguished), is a member of the Law Offices of Oshins & Associates, LLC in Las Vegas, Nevada. He was inducted into the NAEPC Estate Planning Hall of Fame® in 2011. He was named one of the 24 "Elite Estate Planning Attorneys" and the "Top Estate Planning Attorney of 2018" by The Wealth Advisor and one of the Top 100 Attorneys in Worth. He is listed in The Best Lawyers in America® which also named him Las Vegas Trusts and Estates/Tax Law Lawyer of the Year in 2012, 2015, 2016 and 2018. Steve is a highly rated Advisor Webinar presenter and speaks to New York Life audiences on a variety of tax topics.