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Steve Leimberg's Income Tax Planning
Email Newsletter Archive Message #142

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Subject: Steve Oshins on Exploiting the New IRC 199A Pass-Thru Business Deduction Using the Magical 28.57% W-2 Formula and Using Additional Taxpayers

"Although this 28.57% Magical W-2 Formula will be ideal for many business owners who exceed the $315,000 and $157,500 ceilings, with some additional planning, in many cases even superior results can be achieved to even further exploit the new IRC §199A rules. This even works for Specified Service Businesses!

This additional 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."

Steven J. Oshins, Esq., AEP (Distinguished) is an attorney at the Law Offices of **Oshins & Associates, LLC** in Las Vegas, Nevada. Steve is a nationally known attorney who was inducted into the NAEPC Estate Planning Hall of Fame® in 2011. He is listed in The Best Lawyers in America®. He has written some of Nevada's most important estate planning and creditor protection laws. Steve can be reached at 702-341-6000, x2 or at soshins@oshins.com. His law firm's web site is http://www.oshins.com.

Steve authors three different annual state rankings charts and one state income tax chart:

- The Annual Domestic Asset Protection Trust State Rankings Chart
- The Annual Dynasty Trust State Rankings Chart
- The Annual Trust Decanting State Rankings Chart
- The Annual Non-Grantor Trust State Income Tax Chart

Now, here is Steve Oshins' commentary:

EXECUTIVE SUMMARY:

Much of estate planning for 2018 and beyond will focus on planning to maximize the new IRC §199A pass-thru business deduction. This deduction allows certain taxpayers to deduct 20% of their Qualified Business Income. 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 new statute by educating themselves with the details of the statute.

COMMENT:

Dollar Ceilings and Phase-Outs

For a married couple with taxable income of no more than $315,000 and for an unmarried individual with taxable income of no more than $157,500, there are minimal rules and the 20% federal income tax deduction is available. There is a phase-out of the deduction from $315,000 to $415,000 for married taxpayers and from $157,500 to $207,500 for unmarried taxpayers. These figures are for Taxable Income, not just based on Qualified Business Income.

Specified Service Business Rules

For a Specified Service Business, unfortunately no IRC §199A deduction is available for owners whose taxable income exceeds the dollar amounts noted above.

A Specified Service 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 Business Wage and Capital Tests

For a business that is not considered a Specified Service 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 Business: Choice of Entity Example

Assume $1,000,000 of Qualified Business Income (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 above 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 Qualified Business Income is therefore reduced to $714,300.

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

$714,300 * 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 $315,000 ($415,000 phase-out) and $157,500 ($207,500 phase-out) ceilings, with some additional planning, in many cases even superior results can be achieved to even further exploit the new IRC §199A rules. This even works for Specified Service Businesses!

This additional 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 separate non-grantor trust has a separate ability to stay within the $157,500 Taxable Income ceiling. Therefore, this works whether the business is a Specified Service Business or a Non-Specified Service Business.

Back to the $1,000,000 Qualified Business Income Example

Using the same numerical example as above, again assume $1,000,000 of Qualified Business Income (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 Business or a Non-Specified Service 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 Client keeps 30% of the business and has no other income from other assets. Assume that Client gifts 10% of the business to a non-grantor trust for Client's spouse and 10% each to separate non-grantor trusts for each of 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-thru 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 Business (but not with a Specified Service 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-thru 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. But the bottom line is that there are multiple options that can now be used to help our 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-thru 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. Use these ideas as appropriate for the specific Client.

Summary

This newsletter demonstrates how to exploit the new IRC §199A pass-thru business deduction by using the Magical W-2 Formula by paying 28.57% of the business income as W-2 wages. It further demonstrates how to potentially do even better by setting up multiple non-grantor trusts. Once estate planners perfect these new opportunities, there will be nearly unlimited opportunities to exploit these new rules for our Clients.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Steve Oshins

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