Season 1 – Episode 9 - Unveiling the Qualified Business Income Deduction: A Deep Dive into Tax Minimization Strategies

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Host: Daniel J. Rohr, CPA/PFS, EA, M.S. Tax

Welcome to Tax Blueprints, a Rohr CPAs podcast. I'm Daniel Rohr, the managing shareholder of Rohr and Associates, a premier CPA firm based in California. I'm a CPA, personal financial specialist and enrolled agent. I have extensive experience advising individuals and business owners with tax minimization and personal financial planning strategies. On each episode of Tax Blueprints, I delve into the intricacies of tax laws, explain the subtleties of business tax planning, and guide individuals towards a path of financial stability. Whether you're a business owner navigating the murky waters of taxation or an individual planning for a worry-free retirement, Tax Blueprints will provide you with the tools and knowledge you need. I hope you enjoy this episode.

Today we'll be talking about the qualified business income deduction known as QBI and who qualifies for it. We'll also discuss planning strategies to help take full advantage of the QBI deduction. The Qualified business income deduction was introduced as part of the Tax Cuts and Jobs Act in 2017. It allows eligible self employed individuals who operate as a sole proprietorship and owners of pass through businesses such as partnerships and S corporations to deduct up to 20% of their qualified business income on their taxes. So, for example, if you have $100,000 of business income, your QBI deduction is 20,000. You only pay tax on 80,000 of taxable income. You basically get a free deduction. The point of the QBI and why it exists was to somewhat match the benefit to self employed businesses income to the lowering of the C Corp. Tax rate to 21%. Before the Tax Cuts and Jobs Act in 2017, the C Corporation rate was 35%.

Now, the QBI deduction is available for tax years 2018 through 2025. To qualify for the QBI deduction, a taxpayer must be involved in a trade or business, and the income must come from a partnership. Scorpion or a sole proprietorship. Income from a C corporation is not eligible for the deduction. In general, total taxable income in 2023, meaning all of your income, not just business income, must be under $182,100 for single filers and $364,200 for joint filers. Now, I'm going to dive into the detail of these income thresholds and their respective limitations and bear with me on this, because these limitations allow for pinpoint tax planning to save on quite a bit of taxes when utilized correctly. And we'll discuss this a little bit later in the podcast. All right, so when a taxpayer's total taxable income exceeds these limits, the QBI deduction may still be available, but with certain limitations.

The following limitations apply to non specified service, trade or businesses, which are known as SSTBs, which we will define a bit later what an SSTB is. Now, the limitations are based on the amount of W, two wages paid by the business, and the unadjusted basis immediately after acquisition of qualified property. This is known as UBIA. Now, UBIA property is property that includes tangible property with a depreciable life of less than ten years that is owned by the business on the last day of the tax year. Now, for the W two limitation, the QBI deduction is limited to the greater of 50% of W two wages paid by the business, or 25% of the W two wages paid by the business, plus two and a half percent of the UBIA of qualified property. So, for example, suppose Jane owns a business with current income of $500,000, w two wages of $200,000 and UBIA of qualified property of $300,000.

Jane's taxable income is 400,000, which is above the income limit for single filers in 23. Now, in this case, jane's QBI deduction is limited to the greater of 50% of W two wages, which is 200,000 times 50%. So 100 grand, or 25% of W two wages plus two and a half percent of UBIA. When you take that all together, the amount is 57,500 in total. So since 100,000 is greater than 57,500, jane's QBI deduction is limited to $100,000. It's important to note that these limitations are phased in based on the taxpayer's taxable income, and the full limitations apply once the taxable income exceeds the threshold plus the phase in range. So for specified service, trades or businesses, the SSTBs, they're subject to the same income limitations. When it comes to the QBI deduction, the SSTBs include businesses in the fields of health, law, accounting, actuarial, science, performing arts, consulting, athletics, financial services, brokerage services, and it's essentially any trader business where the principal asset is the reputation or skill of one or more of its employees or owners to state the income limits.

Again for SSTBs. So in tax year 23. The taxable income limitation for specified trades or businesses is as follows if the taxpayer's taxable income is below 182,100 for single filers or 364,200 for joint filers, they can

take the full 20% QBI deduction. For taxpayers with taxable income between 182 and 220,000 for single or 364 and 440,000 for joint, a partial QBI deduction is allowed. However, if the taxable income is above 220,000 for single or 440,000 for joint, no QBI deductions allowed for SSTBs. All right, so now that we know the parameters and details of the QBI, how can we make sure to maximize the deduction? Through planning. The trick is basically to make sure you adhere to the income and limitation levels depending on your type of business. If you're a non SSTB and over the income threshold, one strategy to maximize the QBI deduction is to reduce your wages paid to owners, which can increase the business income and in turn, increase the QBI deduction.

There's something called the two sevenths rule, which can help determine the optimal salary for business owners to maximize the QBI deduction. According to this rule, wages paid should equal two sevenths of the total business income. So let's say John owns a non SSTB with a business income of $800,000. Before paying himself a salary, we will compare the QBI deduction when John pays himself a 500,000 wage and when he adjusts his wage to 228,571, using the two 7ths rule. So, for scenario one, if John pays himself a 500,000 wage, his QBI would be $300,000, which is 800,000 minus the 500,000 wage. The QBI deduction is the lesser of 20% of QBI or 50% of W two wages. So in this case, 20% of QBI, which is 300,000 times 20%, is 60,000. Now, the W two wages, they're 500,000, and half of that is 250,000. So John's QBI deduction in this instance is the lesser of 60,000 or 250,000.

So, of course, he only gets $60,000. But if John adjusts his wage to 228,571, using the two sevenths rule, his QBI would be 571,429, which is the $800,000 business income minus his 228,000 wage. So in this case, his 20% of QBI would be 114,286, and his 50% of W two wages is 114,286. So in this scenario, both calculations result in the same amount, and John's QBI deduction would be 114,286. And so, by only adjusting his wage to 228 571, john increases a QBI deduction from 60,000 to 114,000, obviously resulting in a higher tax benefit. So now let's look at SSTBs. So, for specified service businesses, increasing deductions can help utilize the QBI deduction. One way to do this is through retirement contributions, such as cash balance plans or defined benefit plans, where you can make large retirement contributions. Now, by making these large retirement contributions, business owners can lower their taxable income, bringing them below the thresholds and qualifying for a larger QBI deduction.

Let's consider an example of Dr. Smith, a physician with a taxable income of 240,000. Before any QBI deduction and or retirement contribution, dr. Smith's practice generates 160,000 in qualified business income, and he pays himself 80,000 in W two wages. That's where we get the 240,000 of taxable income. Now, Dr. Smith is considering making a $60,000 contribution to a defined benefit plan. So in scenario one, without making any retirement contribution, dr. Smith's taxable income is 240,000, which is above the $220,000 phase out range for single filers in 23, which means he doesn't get a QBI deduction at all. If Dr. Smith in scenario two, let's say, makes a $60,000 contribution to a defined benefit plan, the business income is reduced to 100,000 from the one and 160 because you get to deduct that 60,000 retirement contribution. And Dr. Smith's taxable income is now reduced to 180,000, which is below the bottom of the threshold of 182,100, allowing for the full 20% QBI deduction.

So the full QBI deduction is 20% of 100,000 $20,000. So Dr. Smith makes a $60,000 contribution and gets an $80,000 deduction. Depending on the scenario, investing in the business or investing in yourself through retirement contributions can save a lot of tax for high income SSTBs. So, in conclusion, the qualified business income deduction is a valuable tax break for eligible self employed individuals and pass through business owners. By understanding the rules and limitations surrounding the QBI deduction, you can develop strategies to maximize this tax benefit. As always, it's essential to consult with a tax professional to ensure you're taking full advantage of the QBI deduction and other tax savings opportunities.

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