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QBI deduction optimization is a great end of year planning technique For high income SMB owners.

When used correctly, optimizing has saved my clients tens and hundreds of thousands of dollars annually.

If you are already on it then good for you.

If not - thread incoming■■

The QBI or Qualified Business Income deduction was a part of the TCJA from 2017.

When congress lowered the corp tax rate to 21% they decided to throw a bone to small businesses by offering a 20% deduction on qualified income.

These include Schedule C and pass through entities.

This allows anyone conducting trade or business out of a pass through entity to take a 20% deduction on their income. Great right?

However there are a few limitations including a phase out for high income earners.

The phase begins at 326k for married and 163k for single/HOH.

If your taxable income is above that threshold you are allowed to deduct the lesser of:

1. 20% of QBI
Or
2a. 1/2 W-2 wages (or)
2b. 1/4 W-2 wages + 2.5% unadjusted property basis (RE pros look here).

This means there is a wage limitation to your QBI deduction.

Simple example. Married S-Corp owner makes 300k after he pays employees - what is his deduction? 60k

Ex2. Married S-Corp owner makes 500k after he pays employees 100k total wages - what is his deduction? 50k.

The owner cannot take the 20%, but is limited to 1/2 of wages paid.

SSTB - unfortunately for me and other service professionals the wage limitation rules do not matter, and you simply phase out at the income threshold. This include Specified Service Trade or Businesses in the fields of health, law, accounting, actuarial science, performing arts..

..consulting, athletics, financial services, investing and investment management, trading, dealing in certain assets or any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners.

Real estate is specifically carved out of being an SSTB naturally..

So we have set the table with what QBI is, who gets the deduction and who doesn't. Now what?

This is where the planning begins.

This mostly pertains to partnerships and S-Corps and not so much Sch C filers.

Let's jump back to the example of the 500k owner with 100k of wages being limited to 50k of QBI deduction. What to do??

Well the simplest path is to give a key employee (yourself) a bonus or guaranteed payment draw to reach the optimal amount of QBI deduction.

Yes the bonus will create more SE tax and if you are under the Social Security threshold you should probably be paying yourself more anyhow in this scenario. Also you will get SS credits paying up to the max.

If you are over then you will only pay additional Medicare tax.

The optimal ratio is 2/7 - If you add back the salary to find QBI plus salary (600k in this example) and multiply by 2/7 you will find the optimal salary figure, roughly 171.5k

You would bonus yourself 71.5k (great opportunity to withhold taxes btw) and you will optimize QBI

Your new QBI deduction will be 500k - 71.5k times 20% = about 86k

This simple calculation awarded you a 36k deduction as opposed to if you had just done nothing.

So that is it - that's basically the tool in a nutshell.

The best part about it is the leverage of the whole thing.

Higher income = higher leverage.

This is how this tool has saved a few of my clients millions of dollars. Note the deduction isn't set to sunset until after 2025.

Not done - there are a few other things to consider using the principles of this rule that we have just learned.

1. Reduce income for SSTB - this mostly works best in a single employee S-Corp or closely held partnership.

If you know that you are nearing the 326k income threshold for phaseout there are some things you can do to tamp down your income including retirement contributions.

2. Make employee deferrals - since salaries are not eligible for QBI anyhow, go ahead and make deferrals out of the employee side through a 401k if you are eligible. This is more tax efficient.

3. Don't contribute to SEP, etc. - Knowing that you would get a 20% deduction on that dollar anyhow, your SEP or profit sharing contribution just became 80% of what it was.

When you go to pull it out you will pay tax on the full dollar.

Pay 80% tax today and do ROTH if you can.

4. Aggregation - don't forget that you can aggregate businesses that cooperate with common ownership, management etc. this means you don't have to optimize entity by entity and can save headaches.

If you want to see if you were optimized look at your 2019 8995-A. Look at line 2 and line 16 and they should be the same or very close.

Knowing what you know now, hit the ground running Monday morning and get optimized for the year end!