

Chapter 1 Business Entities and LLCs

- ▲ Mr. Slate operates an online retailer S corporation which pays \$100,000 in W-2 wages and earns \$400,000 in net qualified business income. Because he is considered a “high earner” by exceeding the income limits, his deduction is limited to 50% of the W-2 or \$50,000 which is less than 20% of \$400,000.
- ▲ If Mr. Slate instead operates as a sole proprietor and earns \$500,000 but does not pay any W-2 wages, his deduction is the lesser of 50% of the W-2 wages (or \$0 in this example) or 20% of the \$500,000. If he paid out \$200,000 in wages and had \$300,000 in net business income, his Section 199A deduction would be the lesser of 50% of \$200,000 or 20% of \$300,000.

In other words, he would deduct \$60,000 (\$60,000 is less than \$100,000, even in Canada). He would want to create an LLC, tax it as an S corporation and pay out W-2 wages to maximize his Section 199A deduction.

- ▲ If Mr. Slate instead operates as a specified service trade as defined previously, he would completely phase out of the Section 199A deduction by exceeding the income limit of \$207,500 and \$415,000. This is the specified service trade “gotchya.”
- ▲ If Mr. Slate was married and operated a specified service trade, and the taxable income considering all income sources (spouse, investments, etc.) exceeded \$315,000 but was less than \$415,000, there would be a sliding scale of deduction eligibility. Silly rabbit, tax reform doesn’t mean tax simplification.
- ▲ Fred... yes, we can’t neglect Fred... is single and operates an S Corp as an accountant. Days of busting up rocks for Mr. Slate are in the rear-view mirror. He earns \$100,000 in net qualified business income after paying \$50,000 in W-2 wages to himself.

He is a clearly a specified service trade but because he earns less than \$157,500 total (\$150,000 in this example) he can take advantage of the full Section 199A deduction of 20% of \$100,000. The question of reasonable salary is not being entertained here... focus on the W-2 to income relationship.