



Beat the IRS with Their Own Code: *Using Tax Reform for Early Planning & Lower Tax Bills*

Alexis E. Gallati
EA, MBA, MST, CTC



Contents

About the author	3
Introduction	4
Chapter 1: Tax Planning 101	5
Chapter 2: Tax Cutting Tips	7
Chapter 3: Review of the Tax System	9
Chapter 4: Taxes for the Individual	11
Chapter 5: Retirement Contributions	17
Chapter 6: Taxes on Business Entities	19
Chapter 7: Where Do I Go From Here?	27



About the Author



Alexis E. Gallati
EA, MBA, MST, CTC



After over 18 successful years working for other certified public accounting firms, Alexis Gallati founded Gallati Professional Services in 2014, specializing in the taxation of individuals, small businesses, gifts, estates, and trusts. She has extensive experience in multi-state tax preparation and IRS/State audit representation. Trained at the highest level, Alexis holds two master degrees and is an Enrolled Agent and NTPI Fellow.

When she's not busy helping her clients succeed, she spends her time expanding her knowledge base and providing helpful tips and updates on tax news and regulations on her blog, LinkedIn, Facebook, and Twitter.



Introduction

Are you satisfied with the taxes you pay?

If you're like most people, I assume your answer is definitely not!

Are you confident you're taking advantage of every available break?

Unless you're a tax expert, probably not.

Are your tax and investment advisors giving you proactive advice for saving on your taxes?

When was the last time your tax advisor said, "I think I may have an idea that will save you money?"

The truth is, you're probably not taking advantage of every tax break you can, resulting in you paying more in taxes than necessary. The problem is, most tax professionals work reactively to their clients, waiting for them to address their concerns, and do a poor job of actually saving their clients money.

That's why I wrote this ebook, to share with you some of the best tax planning ideas and teach you how to take advantage of the new tax cuts so you can keep more of what you make. Not only will you walk away with key strategies you can immediately implement in your personal and business finances, but you'll also learn how to get in contact with me to determine if there are other tax saving strategies that may apply to your unique situation.

In the end, it's not how much you make, but how much you *keep* that counts.

Tax Planning 101

There is nothing wrong with a strategy to avoid the payment of taxes. The Internal Revenue Code doesn't prevent that."

- Chief Justice William H. Rehnquist

The biggest mistake that most people make when it comes to taxes is failing to plan.

It doesn't matter how good you and your tax preparer are with a stack of receipts on April 15 — if you fail to plan, you fail to save money.

If you run your own business and didn't know you could use a medical expense reimbursement plan to write off your child's braces as a business expense, there's nothing you can do if you haven't previously set up a plan!

This rule is just as true when it comes to the new tax law. If you run your own business, and you didn't know how to structure your salary to maximize your qualified business income deduction, it's too late to fix that problem!

Right now, somewhere in America, a room full of accountants are learning how to "do taxes" under these new tax rules. And that's fine: "doing taxes" is just as important now as it was before the new law.

But let me ask you this: What do you really want from your tax professional? Do you just want to know how much you'll owe under the new law? Sure, of course. Or would you rather know how to pay less under the new law?



Why Tax Planning?

Tax planning means looking forward to minimize your taxes, not just recording history. What should you do? When should you do it? How should you do it?

Tax planning gives you two powerful advantages:

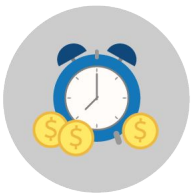
1 **It's the key to your financial defenses.** You have two ways to put cash in your pocket. Financial offense is making more. Financial defense is spending less. For most Americans, taxes are one of their biggest expenses, so it makes sense to focus our financial defense where we spend the most. Sure, you can save 15% on car insurance by switching to GEICO (everybody knows that!), but how much will that really save in the long run?

2 **Tax planning guarantees results.** You can spend all sorts of time, effort, and money promoting your business or chasing *Money* magazine's latest "10 Hot Funds to Buy Right Now!" on your portfolio. But that can't guarantee results. Or you can set up a medical expense reimbursement plan, deduct your daughter's braces, and guarantee savings. You can dump your mutual funds, find a tax-efficient separate account manager, and guarantee more tax efficiency.

Tax Cutting Tips



There are four main categories of strategies you can use to cut your tax bill:



Timing-based strategies, like using 401(k) deferrals to shift today's tax bill to tomorrow. If you are not maxing out your tax advantage funds, start doing it now. Remember, you can always borrow for your kid's education but you can't borrow for retirement.



Income-shifting strategies to move taxable income to lower-bracket taxpayers like your children.



Code-based strategies, like Section 105(b) that may let you deduct your family's medical bills as a business expense.



Product-based strategies, like separately-managed accounts and insurance.



You'll find that most of the new law's changes fall under the code-based category. The Tax Cuts and Jobs Act is the biggest tax bill in over 30 years. And while it may look like 503 pages of nonsense to you, it's important to understand how it's going to affect your wallet.

The main focus is on cutting corporate tax rates. Not only for C-corporations but for the over 90% of America's businesses that are pass-through entities. Congress wanted to lower tax rates overall, but knew it would be difficult to pass corporate reform without promising something to the people who work at those corporations.

Here's the problem, cutting all those taxes costs money. So, Congress had to come up with what they call "pay-fors" to make up for most of that lost revenue. They did it in two ways:

1. They tightened, or eliminated, many of the deductions we've come to take for granted over the years: personal exemptions, state and local taxes, mortgage interest, etc.
2. They phased out most of the personal changes, starting in 2026. Remember the "fiscal cliff" we went over back in 2013? Don't be surprised if we find ourselves facing another one in 2025, unless they extend or make these changes permanent.

Review of the Tax System

Let's review how taxes work for a business owner, so you can better understand the strategies I'll be sharing in the next pages.

First, you'll want to add up all the various types of **taxable income** you receive. If you own your business as a sole proprietorship, partnership, S corporation or LLC, you'll also include that income as well.

Second, you remove certain things that the IRS tells us we can cut out, like IRA contributions and student loan interest. The more things you have on this list, the lower your taxable income.

Then, we continue on our mission to slash away at the income number by subtracting your **itemized deductions**, things like foreign taxes and charitable gifts.

Finally, based on how much you earn, you owe a percentage of what's called "taxable income" to the IRS. The smaller this taxable income number is, the less tax you will pay.

While there are a lot of different strategies that work into this math calculation, this is the basic process. Remember, there are many ways to legally reduce your taxable income, making it simple to reduce your tax payment. However, most people aren't aware of how to do that, so it often gets missed.

TAXABLE INCOME

- Earned income
- Interest/dividends
- Capital gains
- Pension/IRA/Annuity
- Rent/royalty
- Alimony
- Gambling winnings
- Business Income from K-1's

REMOVE ADJUSTMENTS TO INCOME

- IRA contributions
- 1/2 SE tax
- SE health insurance
- Keogh/SEP
- Student loan interest
- No more moving expense or alimony deduction starting in 2018

REMOVE ITEMIZED DEDUCTIONS

- Medical/dental (7.5% limitation)
- State/local taxes (\$10K limitation)
- Foreign taxes
- Interest
- Casualty/theft losses (only special circumstances)
- Charitable gifts
- No more misc itemized deductions starting in 2018

FINAL TAXABLE INCOME



Effects of Tax Savings Over Time

Let's say you didn't realize you could cut out certain things you spend money on from your tax calculation, by the time you've filed, it's too late — it's gone, you've missed it. However, with proper planning, you can create deductions and save money by using pre-tax dollars to pay for your lifestyle, and then pay a lot less tax on what's leftover!

Another added benefit of structuring your taxes this way, is it completely changes the way you grow your wealth for the future.

	Year 1	Year 3	Year 10	Year 20
No Taxes	\$2.00	\$8.00	\$1,024	\$1,048,576
Taxed 35%	\$1.65	\$4.49	\$150	\$22,371
Taxed 25%	\$1.75	\$6.13	\$784	\$802,816

In this chart, you can see the impact taxes have on compounded interest over time. If you were to double a single dollar over 20 years, look what happens when we cut out the taxes on those earnings. As you can see, even reducing your tax 10% down to 25%, has a huge impact on your ability to grow your wealth — \$800,000 versus just \$22,000. So if there's one thing you take away from this ebook, remember:

You lose every time you spend after-tax dollars that could have been pre-tax dollars.

Taxes for the Individual



Major changes in a nutshell

State Taxes

State taxes as an itemized deduction will be limited to \$10,000. Just take a look at your last Schedule A and see if this affects you.

Mortgage Interest

Mortgage interest will only be deductible for the first \$750,000 of the mortgage on mortgages starting in 2018. Interest on a home equity line of credit will no longer be deductible.

529 College Savings Plans

529 college savings plans can now be used for K-12 private schooling. This might help your current year's budget, but taking the college money out to spend on your 6th grader is not wise. This money has been set aside to spread the college expense over many years because college is expensive. Be careful to not fall into the trap of using the money previously saved for college on K-12 private schooling. This new rule will hurt in the long run if you use the money you've been saving for college on today's bills.

Health Insurance

The penalty for not having health insurance will be lifted. As a result, if everyone is not required to have insurance, and insurance companies must pay for pre-existing conditions, premium costs will rise even higher.

Estate Tax

Estate tax exemption will move up to \$11,000,000 for each person. While this won't affect most people, the problem is this number is constantly being changed by Congress. By the time you die, who knows what the rule will be.

Lower Tax Brackets

2017		
Rate	Single	Joint
10%	\$0	\$0
15%	\$9,326	\$18,651
25%	\$37,951	\$75,901
28%	\$91,901	\$153,101
33%	\$190,651	\$233,501
35%	\$416,701	\$416,701
39.6%	\$418,401	\$470,701

2018		
Rate	Single	Joint
10%	\$0	\$0
12%	\$9,526	\$19,051
22%	\$38,701	\$77,401
24%	\$82,501	\$165,001
33%	\$157,501	\$315,001
35%	\$200,001	\$400,001
37%	\$500,001	\$600,001

Here's what tax brackets look like in 2017 versus 2018. As you can see, in 2017 there were seven brackets, starting at 10%, and rising to 39.6% on income over \$418,401. Some people actually paid more than 39.6% if they owed self-employment tax or net investment income tax on top of regular income tax.

For 2018, the tax rates decreased, starting at 10%, and rising to 37% on income over \$600,000. So, not only did tax rates decrease, but taxable income thresholds also increased.

All tax brackets are now paying a lower percentage of their income to taxes. While this is good news, it will be offset by some deductions you will likely lose — so don't spend the money yet.



Case Study - Married with Children

Here's a case study illustrating how all these different factors come into play for a typical American family. The Smiths are married with two children, a golden retriever, and a cat. Mr. and Mrs. Smith each make \$50,000 per year working boring office jobs at cubicle farms in the suburbs. They pay \$12,000 per year in mortgage interest and \$12,000 per year in property tax.

	2017	2018
Adjusted Gross Income	100,000	100,000
Standard/Itemized Deductions	12,700/24,000	24,000/22,000
Personal Exemption	16,200	0
Taxable Income	59,800	76,000
Tax Before Credits	8,038	8,739
Child Tax Credit*	2,000	4,000
Total Tax	6,038 (15%)	4,739 (12%)

Example assumes married couple with two children under age 15, filing jointly with \$12,000 in mortgage interest and \$12,000 in property taxes.

**Child Tax Credit increases from \$1,000 per child (2017) to \$2,000 per child (2018)*

For 2017, they start with \$100,000 in adjusted gross income. Their itemized deductions total \$24,000, which is higher than the \$12,700 standard deduction, so they itemize. And they have \$16,200 in personal exemptions. This gives them a taxable income of \$59,800, a tax before credits of \$8,038, and a final tax bill after the child tax credit of \$6,038. They're in the 15% tax bracket, which means if one of them brings home a \$100 bonus, they'll pay an extra \$15 on that income. And their average tax rate is 6%.

Fast forward a year to 2018, and while their income starts at the same \$100,000, now because their property tax deduction is capped at \$10,000, their \$22,000 of itemized deductions is actually below the \$24,000 standard deduction. That's \$2,000 less than in 2017. And they lost their personal exemptions entirely. That puts their taxable income at \$76,000, more than \$16,000 higher than in 2017. But now their marginal tax bracket is only 12%, not 15%. Their tax before credits is a little bit higher, at \$8,739, but their child tax credits have doubled, leaving them a final bill of \$4,739. Their marginal tax bracket is 12%, which means if one of them brings home a \$100 bonus, they'll pay \$12 tax on that income. And their average tax rate drops to 4.7%.

The difference between the two years is \$1,299, or \$3.56 per day. Yeah, it beats paying more. But nobody's going to plan on getting rich on an extra \$3.56 per day.



Shifting Income to your Children

Now let's talk about a personal tax provision that came as a surprise to a lot of people. In Chapter 2, I mentioned there are four main categories of strategies to save taxes: timing, shifting, code, and product. This law takes dead aim at the classic strategy of shifting investment income to your children so it will be taxed at their lower rates. Before we dive into this new change, let's talk about how the strategy works first.

According to tax court rulings, the IRS approved age for your kids to work in your business is seven-years-old. Yes, I have seen taxpayers get away with making their infant a “working model” for their website, but why poke the bear?

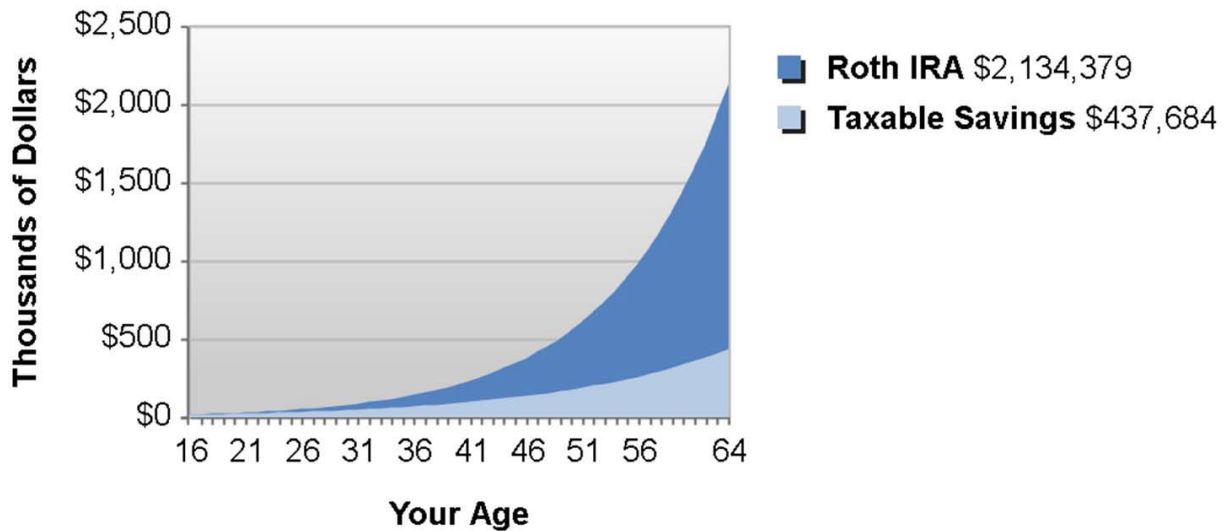
For most of us, our children don't earn a lot of money, which puts them in a lower bracket. Let's say you have \$100,000 in the bank earning \$1,000 in interest. If you're in the 24% tax bracket, you'll pay \$240 in tax on that income. But, if your child is in the 0% bracket, and you put the account in their name, they'll pay nothing. Seems like an obvious opportunity, right?

This means if you're a business owner, you can hire your children, and deduct their pay. They can earn as much as \$12,000 — the standard deduction for singles — in 2018 and pay absolutely no federal income tax. Also, they can earn an additional \$5,500 in 2018 without paying current tax if they contribute it to a traditional IRA.

Remember, your children must perform actual work and be paid in line with what you'd pay nonfamily employees.

Gift Leaseback

Another way to shift income to your children is to gift them equipment or other assets they then lease back to your company. The business deducts the rent as an expense, while your child reports rental income at their lower tax rate. Remember, in 2018 there is a limit per child of \$12,000 tax free, plus \$5,500 tax free if you contribute to traditional IRA. However, you can really stretch this strategy if you have multiple children as they can be in a partnership.



Furthermore, when you hire your kids to work in your business, you are qualifying them to make contributions to a Roth IRA. Now, you know Roth IRA's earns tax free income right?

So, let's say you contribute just \$2,000 per year only up until age 17 for your child. By the time your child reaches retirement age, they'll have over \$2 million tax free in their account, while you've only put in \$20,000 that saved you on taxes.



Kiddie Tax

The folks who write the tax laws aren't stupid, and they see the available loopholes when it comes to investment income. The strategies I just talked about were for income your child earned, but if you open a Uniform Transfers to Minors Act (UTMA) account for them to invest the money they earn, or you just gift them money up to the annual exclusion (\$15,000 maximum in 2018), the investment income they earn through that account is subject to the "kiddie tax" rules.

In 2017 the rules stated that if your child earns more than \$2,100 in investment income, anything above that amount is taxed at your rate, not theirs. Those rules apply until your child hits age 19, or age 24, if they're a fulltime student, and you claim them as a dependent. There's even an alternative minimum tax adjustment.

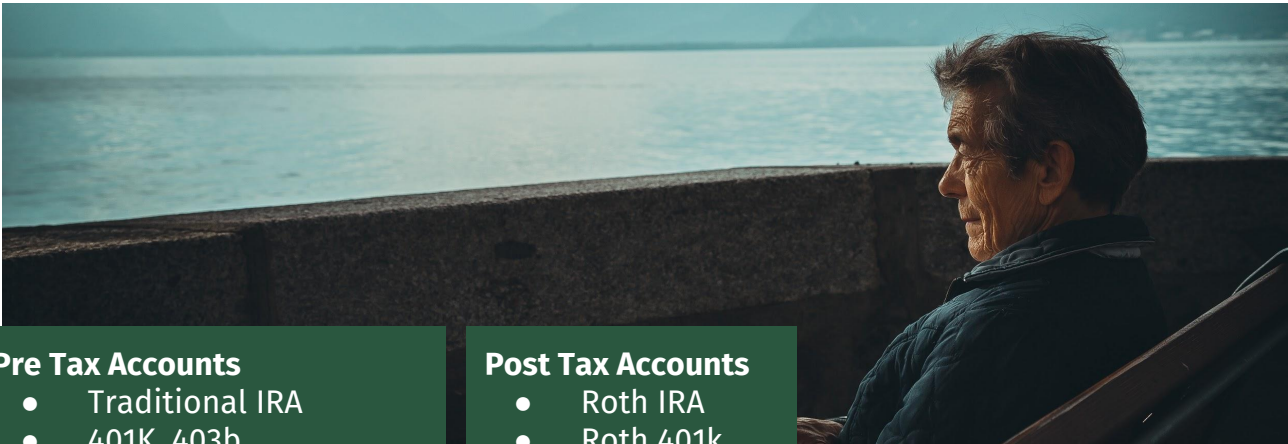
The new law keeps the same concept of special rates on your child's unearned income, but instead of paying tax at your rate, now they'll pay tax at special rates that apply to trusts and estates.

Rate	Single	Trustees/Estates
10%	\$0	\$0
12%	\$9,526	
22%	\$38,701	
24%	\$82,501	\$2,551
33%	\$157,501	
35%	\$200,001	\$9,151
37%	\$500,001	\$12,501

Why is that so bad? Well, just take a look at the rates! They may look better because there are just four of them, but they are *steep* climb. They start at the same 10% as for everyone else, but jump to 24% after just \$2,550 of income, then 35% after just \$9,150, and, finally, to the top 37% rate after just \$12,500.

This came as an under-the-radar change for a lot of people, But it's really going to mean the end of this particular income-shifting strategy.

Retirement Contributions



Pre Tax Accounts

- Traditional IRA
- 401K, 403b
- SEP, SIMPLE
- Defined Benefit Plans

Post Tax Accounts

- Roth IRA
- Roth 401k

I am sure as most of you already know, retirement contributions are one of the best and easiest ways to reduce your overall tax liability and build wealth for the future. Remember we discussed “pre-tax” and “post-tax” dollars. While “post-tax” dollars are ideal for wealth accumulation when it comes to retirement planning because they grow tax free, they don’t provide an immediate tax savings. However, “pre-tax” dollars allow you to deduct your retirement contributions in the year of contribution to lower your taxable income and reduce your tax liability immediately.

So, you’re probably asking yourself, why would anyone want to contribute to their retirement with “pre-tax” dollars?”

Big savings opportunity come with the amount you can contribute to your pre-tax account. With some plans, such as Defined Benefit Plans, you can put away up to six figures of retirement contributions per year. Yes, the contributions accumulate and grow tax free, but you pay tax when you take distributions at retirement. Also, these contributions can be a deduction for your business and, thus, saves you money on self-employment taxes.

Now, while you can’t make a six-figure contribution directly to a Roth, you can convert the pre-tax amount and pay tax on it in the year of conversion. This is a wealth building strategy by converting your pre-tax contributions in a low tax bracket year so you pay less tax in the present and no tax when you take the money out of your post-tax account. However, there was a change to the rules for moving money between pre-tax and post-tax accounts.

IRA Recharacterizations

When you convert a traditional IRA into a Roth IRA and then reverse the transaction by switching the account back to traditional IRA status, the reversal is called a recharacterization in IRS-speak. If you had a sizable accumulation in your traditional IRA, the ability to convert that traditional IRA to a Roth IRA and also change your mind when things were backfiring was a terrific tax and financial planning break.

For example, if you realize your year end bonus was going to be much higher than you expected and you already converted your traditional IRA to a Roth IRA, your tax liability will be much higher than if you waited to do the conversion in the following year. Prior to 2018, you could recharacterize the conversion and it would be like you had never done it at all.

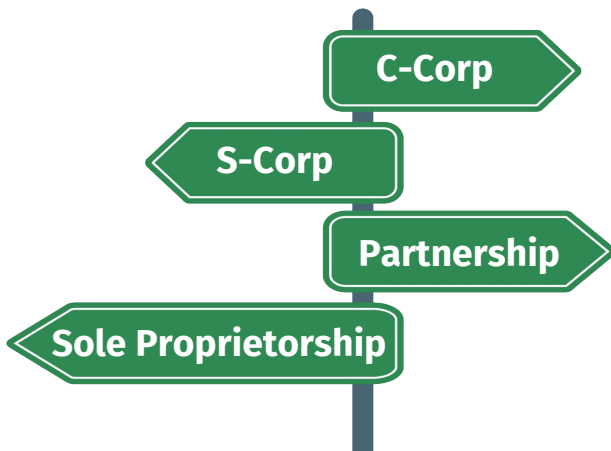
But if you make a Roth conversion transaction in 2018 and beyond, the new tax law eliminates your ability to recharacterize the account back to traditional IRA status.

And, unlike most of the tax reform changes that affect individual taxpayers, this one is permanent. However, other types of IRA recharacterizations are still allowed, such as converting from a Roth IRA to a traditional IRA.

It is important to work with your tax advisor and other wealth advisors to make sure you are converting your contributions in the correct year. Otherwise you may lose out big on tax savings.



Taxes on Business Entities



Now that we've walked through the tax system for individuals, let's talk about how it works for business entities.

The first thing you need to know is that there are four different tax classifications for businesses: sole proprietorships, partnerships, S corporations, and C corporations.

Now, you may be looking at this list and thinking, "Wait a minute, my business is a limited liability company, or LLC. Where do LLCs fall on the list?" The answer is that an LLC is a type of entity, formed under state law, but it's not a tax classification.

LLCs can actually choose to be taxed as whatever entity they want. A single-member LLC, with just one owner, is assumed to be "disregarded," and taxed as a sole proprietorship. However, that same single-member LLC can also elect to be treated as an S corporation or a C corporation.

Likewise, a multiple-member LLC, with two or more owners, will be taxed as a partnership. But those owners can also elect to be taxed as an S corporation or a C corporation.

Corporate Tax Rates

Taxable Income	2017 Rate	2018 Rate
\$0-\$50,000	15%	21%
\$50,001 - \$75,000	25%	21%
\$75,001 - \$100,000	34%	21%
\$100,001 - \$335,000	39%	21%
\$335,001 - \$10,000,000	34%	21%
\$10,000,000 - \$15,000,000	35%	21%
\$15,000,001 - \$18,333,333	38%	21%
\$18,333,334+	35%	21%

Under the new law, things get considerably easier for corporate tax. There's a single flat rate of 21% that applies from your first dollar of income to your very last dollar of income. And, even better news, the new law eliminates the personal service company tax and corporate alternative minimum tax. If you have a credit for prior years' alternative minimum tax, you can carry it forward to offset your regular tax liability.



These new rules will make C corporations far more valuable to business owners, and even investors. Consider these examples:

A

An older owner with taxable income in the 22% bracket or above above, can earn income inside a C corporation, pay tax at the 21% flat rate, and leave the net profit inside the corporation until death, when the corporation will acquire a “stepped-up basis” and be liquidated and distributed tax-free to heirs.

B

Highly paid professionals who incorporate their practice can take income in the form of salary, taxed at rates as high as 40.8% (37% for income tax plus 3.8% for Medicare tax). Alternatively, they can leave profits inside the corporation to be taxed at 21%, then take the after-tax net as a dividend, taxed at 23.8% (20% for income tax on qualified corporate dividends and 3.8% net investment income tax). Together, this will result in a 39.802% rate.

C

You can also use a C corporation as an alternative to a qualified retirement plan. Simply leave earnings in the corporation and withdraw them in a later year when you’re in a lower tax bracket.

D

If you’re nearing the end of your career, and don’t need the income for current living expenses, you can even leave them inside the corporation until your death. At that point, your heirs will enjoy a stepped-up basis on those assets, and can withdraw the accumulated funds tax-free.

Qualified Business Income: A New Kind of Income

Ordinary

Investment

Passive

Qualified
Business

Now we're going to talk about the most dramatic change in the new law.

The Tax Cuts and Jobs Act focused most of its attention on tinkering at the margin of existing concepts. The corporate tax rate is cut to a flat 21%, but the basic framework remains the same. Standard deductions have essentially doubled, but the standard deduction concept remains the same. Personal rates are down across the board, but the basic graduated rate structure remains the same.

However, the law made one very important, and very unexpected, change. Specifically, it defined an entirely new kind of income from pass-through businesses. The tax code has always recognized that there are different kinds of income – and treated those kinds of income differently.

Ordinary income is what you earn from your work or your business. If you earn a salary from a job, and your spouse loses money in a business, you can net those amounts against each other. If you draw pension or IRA income, that's ordinary income too. Ordinary income is taxed at ordinary rates.

Investment income is income you earn from your portfolio. And some of it, like taxable interest income, is also taxed at ordinary income rates. But different kinds of investment income can be taxed at different rates. Qualified corporate dividends, for example, are taxed at special rates and capped at 20%. Long-term capital gains from property held for more than a year are also capped at 20%. Investment income is also subject to a 3.8% "net investment income tax" if your AGI exceeds \$200,000 for single filers or \$250,000 for joint filers.

If you have capital losses in a year, you can subtract them from your capital gains. And you can subtract up to \$3,000 of net capital losses against your ordinary income. But if your net capital loss is more than \$3,000, you have to carry the remainder forward to future years.



By the mid-1980s, taxpayers had figured a way around those first two walls. They discovered they could use borrowed money to increase their basis in investments like real estate, oil & gas, and equipment leasing, and write off huge paper losses, well in excess of what they had actually invested. They used those losses to offset their ordinary income from salaries and businesses, as well as investment income from their investment portfolios. That was great for taxpayers, of course, especially with marginal rates hitting 70%. But it wasn't so good for the U.S. Treasury.

As a result, in 1986, Congress created a new category of income, called **passive income**, that covers activities where you don't "materially participate." The 1986 rules said that you could write off passive losses against passive income, but generally not against ordinary income or investment income. There's a rental real estate loss allowance for up to \$25,000 of rental property losses, but that phases out starting at \$100,000 of adjusted gross income. And so-called "real estate professionals" who qualify under special rules can deduct passive real estate losses against ordinary income. But for the most part, the 1986 rules walled off passive income and losses into their own silo.

Fast forward to 2018, and Congress has now created a fourth kind of income: **Qualified Business Income**.

As we've seen, the new tax law lowered the top tax on C corporation income from 35% to 21%. That's a whole lot less than the maximum 37% tax on pass-through income from sole proprietorships, partnerships, and S corporations. In order to equalize the tax treatment between taxable and pass-through businesses, qualified business income allows you to deduct 20% of that income, calculated on an activity-by-activity basis, from your taxable income for the year.

The new law lets you deduct qualified business income from your taxable income.

That means it's not a traditional adjustment to gross income, or "above the line" deduction, that you would take on Page One of Form 1040. It's not an itemized deduction, either. Now, it's too soon to know what the tax forms will look like. But we'll probably see a line right after the current Line 41, which reports adjusted gross income minus deductions, to report "qualified business income," before calculating final "taxable income."

Defined

- Net income from Schedule C
- Trade/business income from partnerships (but not guaranteed payments or investment income)
- Trade/business income from S corporations (but not W2 wages or investment income)
- Real estate investment trust dividends
- Publicly-traded partnership income
- Qualified agricultural coop income

Limitations on the 20% deduction

- 20% Overall Limit
- W2/Depreciable Asset Limitation
- "Specified Service Business"

Individual Business Income and Wage and Capital Limitation

Taxable Income	Taxable Income	Taxable Income
<\$157,500 Singles	Between \$157,500-\$207,500	>\$207,500 Singles
<\$315,000 Joint	Between \$325,000-\$415,000	>\$415,000 Joint
Deduction Equal to 20% of QBI	Wage reduction is phased in pro rata in each of the calculation steps	Deduction equal to the lesser of 20% QBI or the greater of 50% Wages or 25% of wages PLUS 2.5% of qualified assets

At least the phaseouts themselves are straightforward! They start at \$157,500 for single filers, heads of households, and separate filers, and \$315,000 for joint filers. The phaseout range is \$50,000 for single filers, meaning the 20% deduction disappears entirely once taxable income reaches \$207,500. And the range is \$100,000 for joint filers, meaning the deduction disappears entirely at \$415,000 for joint filers.

You may be asking yourself, "didn't they exclude all high income earners?"

The simple answer is: No. There is a limitation, but not an exclusion if you are part of a high-income family and own a business in the service industry. If you are an independent contractor (paid 1099), in the eyes of the IRS you own a business. Physicians are one of the primary targets of this limitation on the service industry, but the average physician falls under it. The limitation is \$315k of taxable income with a phaseout by \$415k.



Specified Service Business Workarounds

Now let's talk about working around this "specified service business" limit.

Careful Definition

The first opportunity, as we already discussed, involves defining the work you do to fall outside the definition of "specified service business."

These questions suggest the very first potential work-around involves how you classify your income to fly under the IRS radar. Something as simple as choosing the right six-digit business activity code number could make a huge difference here. The IRS is likely to "flag" certain business codes for extra scrutiny, and you'll want to avoid those codes where possible. (Unfortunately, none of us in the industry can tell you now what they are!)

Break Out Non-Service Income

The second opportunity involves carving out a business into component parts to remove at least part of its income from the "qualified service business" category.

Let's say you're a dentist, working to build up your practice and your income. The core functions of your professional practice – cleaning teeth, taking X-rays, and filling cavities – all seem to fall pretty clearly under the umbrella of "health." But marketing your practice, billing your patients, chasing insurance companies for reimbursements, and managing staff, are general overhead functions that any business has to perform, whether they're involved in a service activity or not.

So, why not set up a completely separate business – a “management company” – and establish contracts with your professional practice to provide those non-health related functions? At the end of the year, the net profit remaining in the professional practice will be subject to the “specified service business” limits just the same as it would have been without the management company. But the net profit from the management company should qualify for the QBI deduction.

Naturally, you’d have to dot your i’s and cross your t’s here. You’d have to establish and operate the new entity with the same formalities as any other business. You’d have to negotiate arms-length business contracts between the professional practice and the management company. You’d have to pay the management company a commercially reasonable fee for the services it performs for the professional practice, but not so much that you drain the professional practice of all its income.

Now, will all this really work? Will the IRS issue regulations holding that a business providing administrative support to a “specified service business” is lumped under that same umbrella? Will they hit you with the “step transaction” doctrine, disregard the management company entirely, and disallow the QBI deduction you’ve so carefully created? Honestly, who the hell knows right now?

My own philosophy is you have to be smart and not poke the bear. Every action you take in a successful tax plan has to have authoritative backup, whether through IRS code or Tax Court rulings, and you have to document all your intentions. As long as you have everything well documented and authoritative backup, you will be safe in an audit.

If your business owns real estate, you’ll probably be on safe ground breaking out that real estate and paying the highest justifiable rent.

Qualified Agricultural Co-ops

Finally, there’s a lot of talk about using “qualified agricultural co-ops” to get around the “specified service business” rules. Naturally, we’re keeping an eye out on that possibility!

Where Do I Go From Here?



Now that you understand how the new tax law works, at least from 30,000 feet, let's talk about where to go from here.

You saw how the new law may save you all by itself. But there are a lot of moving parts, especially for business owners. And there are a lot of opportunities you have to plan for to take advantage of.

That's where Gallati Professional Services comes in. We offer true, proactive tax planning to help you make the most of the new tax law, and catch up on opportunities you may have missed under existing law, too.

The process works like going to the doctor. If you're sick, the doctor starts with a diagnosis: what's causing the pain? Then he prescribes a solution – maybe it's a prescription, or surgery, or physical therapy. Finally, someone fills that prescription.

We work the same way. We start by sitting down with you for a free tax analysis where we review your returns to find the mistakes and missed opportunities that may be costing you thousands in taxes you don't have to pay.

Then, we prescribe the solutions to stop that bleeding. Maybe it means restructuring your business entity, or implementing a medical expense reimbursement plan, or rescuing lost depreciation deductions for your real estate.

Finally, we'll fill those prescriptions. In some cases, we'll do it ourselves. In others, we'll bring in a network of specialty vendors who offer services like cost segregation studies, captive insurance management, or charitable trust administration.

We can't tell you how much we can save until we sit down with you for the analysis. However, we can tell you that most business owners are wasting thousands of dollars a year in taxes they simply didn't know they didn't have to pay. You owe it to yourself to make sure you're not one of them!

Are you ready to see how much of your hard earned money you can keep out of the hands of the IRS?

Contact us at 865-281-1461 to schedule a free Tax Savings Discovery Session or email us at info@gallatitax.com.



Mailing Address:

2042 Town Center Blvd PMB110

Knoxville, Tennessee 37922

865-281-1461

agallati@gallatitax.com

www.GallatiTax.com