REFLECTIONS

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WINDGATE
WEALTH MANAGEMENT

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BUSINESS OWNERS GUIDE TO THE NEW 20% TAX DEDUCTION

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There's a new tax deduction created by The Tax Cuts and Jobs Act of 2018 (TCJA), and if you own a business or a partnership you need to be informed. The new IRC Section 199A deduction (also known as the pass-through deduction) will allow some businesses to be taxed on only 80% of their income. This significant tax break is highly complicated, but the planning opportunities for business owners or members of a partnership are tremendous. Here are the basics you need to know about the deduction:

What is the Pass-Through Deduction?

The new pass-through deduction allows you to deduct up to 20% of your Qualified Business Income. This will effectively permit pass-through businesses to be taxed on only 80% of their income. The new deduction was created to even the playing field between pass-through businesses and corporations, as it provides an incentive to businesses who elect not to become a C Corporation despite the lower corporate tax rates now available with the passing of the TCJA in 2018.

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If you have any questions or comments, or if you know of any friends or family that might benefit from our services, please give us a call at 844.377.4963

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Who is the Pass-Through Deduction for?

The new Section 199A deduction is available for owners of any business that is not a C Corporation. This includes S Corporations, Partnerships, LLC entities, and sole proprietors who are paid directly as independent contractors. To get the deduction, a business must have "Qualified Business Income" (QBI). QBI is defined as any business income after regular expenses (expenses would include your salary if you operate as an S Corp). Put simply, QBI is your profit.

Limitations on the Pass-Through Deduction

The pass-through deduction can provide a huge tax break for many business owners. However, there are several limitations that need to be navigated through to maximize the benefit. First, your pass-through deduction is limited to 20% of your taxable income. So, if all your household income comes from QBI (i.e. you have no other income to report from a salary, spouse, etc.) then your typical standard or itemized deductions will eat into your pass-through deduction.

The other big factors that can affect your deduction are the nature of your business and your taxable income.

The pass-through deduction will allow some businesses to be taxed on only 80% of their income.

Lawyers, Doc's and Money

While the 20% deduction is attractive, it isn't distributed equally. If you are a professional in a "specified service business," which includes (but is not limited to) industries of health care, law, finance, and accounting, the 20% deduction is phased out and eventually eliminated once certain income levels are met. The phaseout range is $157,500-$207,500 for single filers and $315,000-$415,000 for those who are married.

Notably, the phaseout is based on income shown on your personal tax return income, not just the amount of your business income. For example, as a physician you may earn $250,000 in profits, putting you under the $315,000 limitation. But if you file taxes jointly and your spouse separately earns $250,000, your personal tax return income of $500,000 now exceeds the limit, and your deduction will be eliminated.

Non “Specified Service” Businesses

For those who don’t own a “specified service” business – for example, income generated from a real estate business – the pass-through deduction is still available even when you earn more than the $207K/$415K income limitation. For non “specified service” business owners to still qualify for the deduction above the high-income limits (below the income limit you qualify regardless), you need to pass a wage and property test. The deduction will be the *lesser* of 20% of QBI, OR the *greater* of either:

- 50% of the W-2 wages in the business: or
- 25% of the W-2 wages plus 2.5% of the basis of all qualified property in the business.

For example, if you own real estate providing an annual QBI of $500,000, your deduction “should” be 20% of that $500,000, or $100,000. But this $100,000 potential deduction first needs to be compared to the wages you pay any employees (including yourself) and the basis in your properties based on the rules above.

Strategies to Maximize Your Pass-Through Deduction

Understanding what the pass-through deduction is and how to qualify for it, your next step is to take possible action to maximize your tax savings.

Here are **three possible strategies** that might provide the biggest tax break for your business:

1. Lower Your Taxable Income with Retirement Plans

Many physicians, attorneys and other high-earners in the "specified service" business will lose their pass-through deduction due to the $207K/$415K income limits. The good news is that increasing contributions to a retirement plan can help business owners who don't qualify for the 20% deduction to become re-eligible. This is especially effective when layering a cash balance plan that allows for higher contributions than the $18,500 limit on top of a traditional 401(k).

Because retirement plan contributions reduce your taxable income, additional plan contributions can help you fall below the $315,000 phase-out limit, thus making you eligible for the 20% pass-through deduction. This means that plan contributions not only reduce your tax dollar for dollar, but also can trigger an additional 20% deduction on your income.

The good news is that increasing contributions to a retirement plan can help business owners who don't qualify for the 20% deduction to be re-eligible.

The example below shows a business owner earning $200K in salary and an additional $300K profits before and after making a $185K contribution to a cash balance 401(k) plan. Without the retirement plan contribution, the owner makes too much and is not eligible for the deduction. **Because the pass-through deduction is triggered in scenario #2, a $185,000 contribution creates a $208,000 reduction in taxable income.**

MARRIED BUSINESS OWNER OR PARTNER IN THE HEALTHCARE PROFESSION WITH $500K INCOME			
Scenario #1		Scenario #2	
W2 Salary	$200,000	W2 Salary	$200,000
Cash Balance Contribution	$0	Cash Balance Contribution	$185,000
Qualified Business Income (QBI)	$300,000	QBI	$115,000 ($300,000-$185,000)
Taxable Income	$500,000 (exceeds $415,000 limit)	Taxable Income	$315,000 ($500,000-$185,000)
20% Deduction	$0	20% Deduction	$23,000 (20% of $115,000 QBI)
Net Taxable Income	**$500,000**	**Net Taxable Income**	**$292,000 ($315,000-$23,000)**

2. Adjust Your Salary or Partnership Payments

The salary you pay yourself as an owner of an S Corporation is not considered business income and therefore not eligible for the QBI deduction. Same goes for guaranteed payments from a partnership. So, if you are eligible for the 20% deduction, the after-tax value of income paid to you via QBI profit distributions will be greater than that paid via salary or guaranteed payments, because with profits the deduction gets applied.

Overall, paying yourself less in salary or making a simple "revision" of a partnership agreement to adjust guaranteed payments can increase the amount of your 20% deduction. Of course, in the case of an S Corporation, make sure that you are paying yourself a "reasonable" salary as to steer clear of any issues with the IRS.

If you are in a non-service business, it may make sense to actually pay yourself more (see #3 below). So much for simplifying the tax code.

3. Revisit Your Business Entity

While the Section 199A pass-through deduction is available to all businesses operating as S Corporations, Partnerships, LLC entities, and sole proprietors, your personal ability to maximize the benefit may be closely related to which entity you use.

Recall that if you are in a non-service business with a high-income, your 20% deduction is limited by the wages you're paying yourself (or others). This is an example where having the right business entity can create new tax savings.

Consider a sole-proprietor with a real-estate business earning above the $415K income limit (remember it's $415K on the family tax return, not just this business). Because this is not a specified service business, you could still qualify for the 20% deduction despite earning above the income limitation. However, you are limited by how many wages are paid (see the 50% wage rule above). With no wages as a sole proprietor, 50% of $0 = $0, and the deduction is eliminated. By converting into an S Corporation and paying yourself a reasonable salary, the 20% deduction is now allowed, possibly providing significant tax savings above and beyond any costs of restructuring.

Given that we are dealing with the IRS, there's also a scenario where the opposite action could be advised, demonstrating both the complexity of the new tax law and the fact that planning around Section 199A needs to be a highly personalized strategy.

A change from a S Corporation to a Partnership or LLC could result in a lower tax bill for a business owner in some circumstances. This is because, as stated above, the salary you pay yourself as an owner of an S Corporation is not considered business income and therefore not eligible for the QBI deduction. Taking all income as profits via a LLC or Partnership and none as salary could maximize your tax savings, as long as there is no need to navigate any wage limitation tests (i.e., if you earn under the high-income limit, this could be an option to explore). Changing the nature of your payment will also affect your FICA and self-employment taxes, so you should certainly seek the guidance of your tax-professional.

We Can Help

The new IRC Section 199A pass-through deduction can provide business owners with large tax breaks and tremendous planning opportunities. However, it is highly complicated and demands a personalized strategy. If you would like to discuss any options that are specific to your situation, you can reach us at Windgate Wealth Management by calling (844) 377-4963 or emailing windgate@windgatewealth.com. You can also book an appointment online.

This significant tax break is highly complicated, but the planning opportunities for business owners or members of a partnership are tremendous.

IN MEMORIAM - DR. GERALD "JERRY" W. PERRITT

As many of you are aware, Dr. Gerald Perritt, the founder of our firm, passed away recently. Many of you knew him well as an advisor, a teacher, and a friend. All of us at Windgate Wealth Management are saddened by the loss. We will always remember him fondly.

Dr. Gerald "Jerry" W. Perritt

"We are sad to report the loss of our founder, friend, teacher, and mentor. Dr. Perritt was a pioneer in the mutual fund industry. He was one of the first in the industry to track performance and industry dynamics, and to champion mutual funds as an investment option. He launched *The Mutual Fund Letter* in 1981, a monthly newsletter tracking the mutual fund industry. Dr. Perritt's flagship newsletter was *Investment Horizons* where he wrote about micro-cap investing. He also created the Perritt MicroCap Opportunities Fund, one of the first micro-cap mutual funds, in 1988."

-Michael J. Corbett, current CEO of Perritt Capital Management/Windgate Wealth Management.

Dr. Perritt was a prolific writer, sharing his insights and expertise through newsletters and books, including *Small Stocks, Big Profits, Mutual Funds Made Easy* and *Expanding Your Investment Horizons*. He was also a columnist for *Forbes Magazine*. Dr. Perritt was frequently quoted in such publications as *The Wall Street Journal* and *Barron's*. He was always generous to share his wisdom, knowledge, and experience with his staff, grooming successful investors.

Teaching was a passion for Dr. Perritt. He taught and mentored many throughout his illustrious career. He served as professor at several prestigious universities, including Ball State University, Babson College, University of Miami, and DePaul University.

Our thoughts and prayers are with Dr. Perritt's family and loved ones.

THREE TAX-SMART WAYS TO HELP YOUR CHILDREN

Listen up parents: it costs over $230,000 to raise a child from birth through age 17, according to the latest spending report from the USDA . Faced with a six-figure commitment, you might as well do your best to mitigate taxes while providing for your children.

Giving gifts to children has long been an advantageous estate planning strategy for affluent families. Because gifted assets are removed from your estate, they are not subject to the hefty 40% estate tax rates. The calculus changed significantly with the new tax law passed in 2017, as the Federal estate tax is now only triggered for assets above $22 million, sheltering most families from any impact. State estate tax rules vary however, for example in Illinois the estate tax is levied on assets over $4 million.

For the 2018 tax year, you can gift $15,000 per person, or $30,000 per couple, to any individual. Gifting is still a useful strategy, as future estate tax law is unknown. In addition, gifting strategies can help you pay less tax in a current year, increasing the value of both your gift and your portfolio. Before you gift your child cash, stop and consider these three tax-saving alternatives:

1. Gift Stock Over Cash

Gifting appreciated stock can be a great alternative to simply giving your children cash. The reason is that by giving away stock that has appreciated in value (and held at least 12 months), you do not need to recognize the capital gain in the process. By gifting appreciated stock, you avoid any long-term capital gains tax liability that you would otherwise owe in the future.

Any capital gain liability does transfer to the recipient of your gift – there is no "step-up" in cost basis when gifting stock; this occurs only at death. So it helps to know more about your child's tax situation. For example, this strategy works best if your child is in the 10% or 15% tax bracket, as these individuals have a long-term capital gains rate of 0%. Nonetheless, if your child is in a lower tax bracket than you, gifting appreciated stock will have a better result than selling stock and giving the cash.

https://www.cnpp.usda.gov/sites/default/files/crc2015_March2017.pdf

Example of Gifting Appreciated Stock

If you were to gift old shares of XYZ stock that you bought for $20 per share and now has a market price of $120 per share, your child will receive your cost basis of $20. This means that they would have a $100 per share capital gain on which they owe taxes. However, if they are in a low enough tax bracket (10% or 15%), they may pay nothing in long-term capital gains. Had you gone ahead and sold the stock yourself, at the highest tax bracket, you would have paid up to 23.8% tax on the gain.

In addition to considering the step up in basis, you also might consider the holding period. For example, if you had held the stock for five years, the holding period would apply to your child and be considered long-term capital gains.

In the instance that your child is in a higher tax bracket and you are too, gifting appreciated stock may be a strategy to avoid. In this instance, you might instead gift cash, or stock that has minimal appreciation. Remember, if you bequeath the stock after you pass away, the cost basis is "stepped up" to the value of the stock on the date of your death, meaning that they now have (from example above) a $120 cost basis per share, and thus no capital gain if they sell it immediately.

Other Considerations

Another consideration has to do with the age of your children. Steeper taxes apply to gifts that are made to young relatives. Gains from investments that exceed $2,100 and that are given to children under the age of 19 (or college students age 24 and younger) are taxed at higher trust rates.

2. Contribute to a 529 College Plan

A 529 plan is perhaps the most common method people use to save for college. A 529 plan is a state-sponsored education savings account that allows earnings to grow tax-free. This means that 100% of your growth can be used toward the tuition and is not whittled away paying annual taxes, which can have a big impact on the bottom line. 529 plans also have a special rule which allow you to make a lump-sum contribution equal to five times the annual gift tax amount, up to $75,000 per individual or $150,000 per couple.

New to the tax law in 2018, 529 plan assets can also be used to pay for private school tuition for K-12th grade, up to $10,000 per year. Check with your state's plan first, as some states (including Illinois) have yet to embrace the new federal rules.

3. Gifting to a Roth IRA

Roth IRAs are a widely popular investment strategy and for good reason: qualified Roth IRA earnings are tax-free and there is no required minimum distribution (RMD), making these accounts a powerful tool for long-term wealth building.

What many may not know is that children can make Roth IRA contributions if they have compensation. And these contributions can come in the form of a gift. So, if your 15 year old daughter or granddaughter has earned $5,500 at a summer job, you can gift them up to $5,500 (the maximum annual contribution) to invest in a Roth IRA in their own name.

MIDTERM ELECTION YEAR MARKETS

Midterm elections are (finally) over. It would appear markets don't enjoy midterms either, as we experienced a correction in October leading up to the election day. The S&P 500 dropped nearly 10% in October, its worst month since February 2009.

There are many possible explanations for the recent correction, though the most plausible one is that the markets had run too far, too fast. Remember, we are currently amid a nine-year bull market. On average, we experience a 5% correction about once a year and a 10% correction about once every two years. Following a historically low year for volatility in 2017 (the S&P Index was up each and every month for the first time in history), October's 10% correction was in fact our second largest drop of 2018, with a previous 10% correction in Jan/Feb this year.

Midterm Election Year	Market Correction During the Year	Market Performance 1-Year After Correction
2014 (Obama)	-7.20%	10.72%
2010 (Obama)	-16.10%	30.02%
2006 (Bush)	-7.00%	25.47%
2002 (Bush)	-33.38%	33.52%
1998 (Clinton)	-18.53%	34.68%
1994 (Clinton)	-8.74%	24.88%

Source: Capital IQ

Market represented by the S&P 500 Index

Volatility is normal and during midterm election years that has been even more true, historically. Below is a table showing market corrections during some of the recent midterm election years. Note that despite regular corrections in midterm years – some of them extreme – market performance one year after the correction has historically been very positive.

Of course, we cannot know if the next year will follow the same pattern. But midterm elections generally offer inflection points. Regardless of who wins in a midterm, every President typically aims to stimulate an economy before the upcoming second term elections. Will markets agree? Only time will tell.

WINDGATE

In The Community

Big Shoulders Fund's mission is simple. They provide support to inner-city schools which provide a quality, values-based education for Chicago's children.

Big Shoulders Fund®

Stacie Suhrbur of Windgate Wealth Management and Kathy Schutz of Perritt Capital Management work with the Stock Market Program which brings business professionals into eighth grade classrooms to teach basic concepts related to the stock market, investing, and careers in business. Under the leadership of Big Shoulders Fund Directors Charlie Bobrinskoy and Jim Hoeg, students in the program build a virtual portfolio tied to actual financial incentives for their school. Starting with 3 schools back in the 2008-2009 school year, the program has expanded to 62 schools for the 2017-2018 school year.

The Stock Market Program provides the opportunity for eighth grade students to learn about the financial markets, personal savings and investing concepts, and careers within the financial industry.

Kathy is currently in her 8th year of volunteering within her 3rd Chicago school. Kathy was asked why she chose to dedicate her time to this charity and this program. She explains her concern for the lack of financial education in schools when it is so necessary to do well in life. Kathy likes that the program gives information that many adults to not have at a young age.

The Perritt/Windgate team is one of only a few that are also working with 7th graders. Kathy expanded her outreach to offer a deeper understanding of money to the students. This growth has allowed Stacie to utilize her social work and autodidactic facilitating background. Stacie began by utilizing an open dialogue format, so students could ask any and all questions regarding money. Under the category of 'kids say the darndest things': "How come when I ask my mother how much she earns, she tells me that it is government information? Well maybe because she actually does work for the government." All questions, whether open ended or fact driven are answered with respect for the question and questioner. If the answer is not readily available, it is brought to the next meeting.

Perritt Capital Management and Windgate Wealth Management support the dissemination of valid and sound financial information via education; especially early in life.

If you have any questions regarding any of the above ventures, please see:

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https://bigshouldersfund.org/our-programs/stock-market-program/

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