The Biz Beat Podcast – Episode 13: Making QBI Permanent, Interest Expense Changes, and HR Tips for Business Owners

Lee: Hello everybody, and welcome back to The Biz Beat by SVA, where we break down what business owners need to know about taxes, legislation, and strategies that impact your bottom line. I'm Lee Schwartz, Director of Business Development and Sales at SVA, and I'm joined, as always, by Eric Trost, Principal and President. Eric, welcome back.

Eric: Great to be here.

Lee: All right, we have been covering a lot of different topics of this Big, Beautiful Bill over the last, well, since we've really started the podcast. Our format has changed a little bit. What we're going to start doing, and what we did last week, is we're going to bite off a couple of topics each week to talk about, get into them a little bit deeper, and then move on to a mailbag question. We didn't have time for that mailbag question last week, but we're going to try and get to it this week.

Lee: So last week we looked at bonus depreciation and R & D. This week we're going to look at qualified business income deduction and some business interest expense issues. So but before we get into that, I just want to put a plug in. We do, I know we talked about this last week, we've got our big, hour long webinar coming up next Tuesday, July 22 at noon central. We'll be digging into what these tax changes could mean for your business. So, if you're looking for some deeper insight, that's the place to be. You can register at sva.com/events.

Qualified Business Income (QBI) Deduction

Lee: But Eric, let's get into our first topic here. That's the 20% QBI deduction, making that permanent, expanding who qualifies. Can you talk a little bit about what that means for business owners?

Eric: Right. So little background. The qualified business income deduction, which is new from 2017, was set to expire at the end of 2025. What it is is a deduction allowed for business owners that run what's called flow-through businesses, or businesses that appear on their individual return. So different ways to report business income and run your business. One of the ways to do that is to do it such that the income is reflected directly on your individual return. So this is a deduction for those that report their business income ultimately on their own return. And what it does is it lowers the top tax rate that your business would otherwise be taxed at if it was, for instance, wage income.

Eric: So there's what I call, like a hierarchy of income, and I'll just break down three types of income that you can have, from the best to the worst. The best is real estate income, owning rental real estate properties because of depreciation deductions. The worst is wages. So those that are working in typically service industries like the legal world or doctors, accountants, we get paid a wage. That is the worst type of income, because you get payroll taxes and full boat income taxes on it. The middle is business income. Business income might have additional payroll taxes on it that wage earners have, but it is allowed a what's called a qualified business income deduction, which is effectively, if you make $100 in business, you're going to be taxed on $80, so there's a 20% deduction for that.

Eric: There's limitations that apply, and different kinds of businesses can't always take advantage of it, such as the kinds of businesses I mentioned earlier that wage earners have, like the legal field, the physicians, doctors, accountants, but for the most part, many general businesses can take advantage of this deduction. So if you make $100 you get taxed at $80, as if you made $80. Now, this deduction, new in 2017 that was put in place, was scheduled to expire at the end of 2025, so at the end of this year. That deduction now has been extended, and there is no expiration date on it. So there is no end date on it. That doesn't mean it's never going to end. It just means that unless Congress does an act to change it, it will not end.

Eric: So in 2017 there was a scheduled expiration of it to 2025. Now there is no schedule expiration of it. So if Congress is going to end it, they're going to have to affirmatively change to end this. So it's good news for business owners and planning for the future.

Lee: So Eric, help maybe dumb this down a little bit for someone like me who's not a CPA and I don't do taxes. If you are an owner of a pass-through entity, let's say an S corporation, you're paying yourself. You do have to pay yourself a wage, right? You are paying some payroll taxes.

Eric: Right.

Lee: Then can you break down so anything after that, what you're saying is there's a 20% deduction, but then also you're not paying any payroll taxes on that as well. So that's kind of a double, a double benefit?

Eric: Yeah. So let's talk about an S corporation. Let's say you own an S corporation, and your business earns, before your salary, $200,000, okay? Now there's different ways to take that $200,000 out of your company. The IRS would require that you take a salary that's commensurate with your efforts. So you have to take some salary out of there, considering the efforts that you put into that. But let's say that salary is $125,000, okay? So you'll be taxed as a wage earner on $125,000, which is the highest tax you can pay, and then the remaining $75,000 will come out as a distribution. It's also taxed, but it's not subject to payroll taxes and it gets the 20% deduction.

Eric: So instead of paying tax on that $75,000, you're going to pay tax on 20% less than that, which is $15,000 of 75, so $60,000, so you can pay tax on $60,000 instead of 75. You want to check my math. You never, you never want to do math on a live on air podcast.

Lee: I can't check your math, so you know.

Eric: Not that this is live, but I'm not going to take the time to go back and fix it.

Lee: Well, you'll see, like, some, some bad, you know, like dubbing over overlap in later.

Eric: Right. Yeah, yeah. And another language, yeah, exactly. So now imagine, instead of 125 it turns out that really your efforts only are producing, say, $60,000 worth of wages. So we'll take that same $200,000 and let's take $60,000 out as wages. That means $140,000 now is tax coming out as a distribution, and it's now subject to 20%, which is now you get a $28,000 deduction off that 140, so that's $112,000 you'll pay tax on. So in that case, the less you're paying in wages that then the less you'll end up paying in both payroll taxes and income taxes, because the flow through portion gets that 20% deduction.

Lee: And Eric, I don't want to get too into the weeds here, but how, you talked about sort of that reason, pay yourself a reasonable salary. How do you determine what's reasonable?

Eric: Right. So, a reasonable salary, I think, is you'd compare yourself to others that are in the same position that you're in within the company. Now, it's hard to do that if you are the, say, president of the company, because there might be only one president within your company. You might want to look at other roles within your company, though, and say, should the President make more than these other roles? So perhaps you're going to be the highest paid person in the company. But you also have to factor in the time you're putting into it. Some folks are running companies, but they might have multiple things going on. They own real estate, they do other things part-time. They do volunteer, and so they're not making it a full-time job.

Eric: So in that case, maybe the full-time job for the president of the company should be $120,000 but perhaps you're only putting in 20 hours a week, say, instead of 40 hours a week. And that's why your wage could be $60,000 instead of $120,000. You know, adjusted to full-time, you're still making the right salary, $120,000 but now you can adjust it backwards, because you're really part-time. So $60,000 would be a fair salary for your half-time. So that's how I look at it is, look at what a full-time equivalent salary should be for that position, maybe compared to other positions in the company or outside the company, and then roll it back if you are not full-time within that company.

Lee: Okay, but super important to be looking at that on a regular basis, otherwise you could be paying more in tax. Or on the flip side, if you're not paying yourself a reasonable salary, you could be drawing the attention of people you don't want to draw the attention of.

Eric: That's right. That's right. It's each side. One side is you're on the tax savings, but you're also balancing that with knowing that, should it ever be looked at by taxing authorities, you want to have a position for your case to say, here's why I'm paying myself, what I'm paying myself. You know, some people want to try to get away with zero salary and take everything out as a distribution. While that's the best tax answer, the IRS does red flag those returns that say a compensation of Officer zero and everything's coming out as a distribution.

Lee: Great. Okay. Thank you for explaining that. And that, and that, again, is that's an extension of kind of what's been happening over these last, whatever, seven, eight years since the TCJA went into effect. So this is now permanent.

Eric: Yeah, that's right. So the important thing, aside from some of the planning opportunities we just talked about, is this is now permanent. So it's something that was going to expire. Now it's permanent, and you can count on it for planning, at least until the next regime gets in.

Interest Expense Limitation Changes

Lee: Okay, so let's talk about the next topic. Can you explain how the bill changed the interest expense limitation rules?

Eric: Right. And so the interest expense limitation rules also came into effect in 2017. This is one of the Tax Cuts and Jobs Acts provisions from 2017 that was not taxpayer friendly. Most of the things that came in were taxpayer friendly. This one is not taxpayer friendly. And basically what it did is limit the amount of interest expense your business could deduct. And it made that limitation based on how much income you were making. So, the more income you made, the more interest you could deduct. The less income, the less interest you could deduct.

Eric: That cap in 2017 was 30% of what they called adjusted taxable income, and they changed the definition of adjustable taxable income starting in 2022. That definition in 2022 was Earnings Before Income Taxes, Depreciation and Amortization. That's called the EBITDA for short: Earnings Before Income Taxes, Depreciation and Amortization. So that's an if you're learning that term new, you want to start throwing that around all the time, because it'll make you sound like a financial whiz. What's the EBITDA of that business?

Eric: So the upside of the EBITDA calculation, and this was in place, I should say, through 2022, was that you could add back all these things to your income to then calculate your 30% limitation. So the higher you could get your adjusted taxable income, the higher you could get your interest deduction. So from 2017 to 2022 you were using EBITDA. After 2022, you were not using EBITDA. You were basically just using your earnings, so you didn't get to add back your depreciation and your amortization. Essentially, you were, you were using EBIT: Earnings Before Income Taxes, to calculate what your business income was to then do your 30% limitation on your interest expense.

Eric: So again, what you're looking at is there is a cap on the amount of interest expense you can take. That started in 2017. From 2017 to 2022, that cap was based on 30% of EBITDA, which at least, was a bigger number than EBIT. The EBIT number, you know, so you don't add back depreciation and amortization, was a smaller number, meaning a smaller cap. That was from 2022 through today, 2025, that's still in place.

Eric: What the interest expense rules did is now open that up and said, We're going back to EBITDA. So starting in 2025, this year, with the new bill, that interest expense deduction is now based, the cap is now based on EBITDA, which is a bigger number. So the cap in place is bad news for businesses, but the raising of the way adjusted taxable income works is now good news. So this is a good news for businesses, because they get this higher limitation on interest expense.

Lee: So Eric, now adding back in depreciation and amortization. Who's this most likely to affect? Is this, you know, companies who've been, you know, have big, like, capital investments or, like…

Eric: Yeah.

Lee: What industries are really kind of liking this?

Eric: Yeah, so there's a couple of industries that are liking this rule. One is it only applies, by the way, and this has been through 2017 when these rules came in. It only applies to businesses with about

$30 million or more in sales. And is this number changes over time and with inflation, so just using the $30 million here. So if you're under $30 million in sales, in general, these rules don't apply at all, and so you don't have to worry about them. If you're over $30 million, you have to worry about them, and there's different calculations you have to do with respect to your return.

Eric: So number one, it applies to large businesses. Number two, it applies to businesses that have a lot of interest expense. So that includes businesses that would have capital improvements typically funded by debt that creates interest expense. But also it can apply to businesses that tend to have a longer turnaround time to turn their receivables and inventory back into cash.

Eric: So typically, let's say a distributor, they would take in product, and they would have to pay the supplier of that product. The longer it takes to move that inventory and sell it, we'll have that delay there has to be funded somehow, and oftentimes that's funded by debt or line of credit. And so let's say that a product comes in on day one and you have to pay for it on day one. Say, the vendor insists on that. So you paid to the vendor on day one, then on day 90, you sell that product, but you don't collect that cash that you sold on that product to even 60 days later. So now that's day 150. So essentially, what you've done is you've paid for something on day one, and you finally sold it and collected the cash on day 150. During that time, companies often use debt to fund that time difference. So they borrow the money to buy the product, and then they pay that money back when they finally sell the product. And the interest cost is effectively one of their costs of doing business.

Eric: Those kinds of businesses, if they have those delays that carry inventory, they carry receivables, often have lines of credit to help fund those delays. Those lines of credit carry interest, and that's the interest expense, then that could end up being subject to this cap.

Lee: Okay, that's, I followed 90% of that. I'm sure many of our listeners did, especially if they're over $30 million and they have a line of credit like they, I'm sure they got it at least. But no, great job explaining that. Eric, anything else on on that topic until we move on to our mailbag?

Eric: I think I beat that one pretty hard, don't you?

Lee: I think we got to cut some out, actually. No, that was great. Thank you.

HR Tips for Business Owners

Lee: So we did get this question in. I know two three weeks ago, we haven't had a chance to get to it, but here we are. Eric, the question that we got in was, what's your number one tip for HR managers of manufacturing companies that would help both the company and employees?
Eric: Right. So I would say that I'm going to come at it from a tax perspective. There's a couple of things I think HR managers should be looking at. Start with compliance. And this one is obvious, but you want to make sure your payroll taxes are being paid and submitted and all the forms are in. Companies sometimes get in trouble with that, and the penalties that for not submitting payroll taxes on time or some of the forms in can be very, I don't know. What's a good word for cruel? Government overreach?

Eric: So they can fall into that category.

Lee: Let's just say painful, painful.

Eric: Painful is a good word. So that's one thing. Now, that's for all businesses. Second thing, and this does pertain more to manufacturing companies. There's some new provisions within this bill related to overtime. And we've probably heard, or you probably heard, that there is no tax on overtime, and it's not quite that way, and we'll get into this section more in a future podcast, but for now, know that as an HR department, you want to start tracking overtime and overtime premiums. Eventually, there's going to have to be some kind of reporting on that, and I don't think any forms have come out yet for this reporting in response to the One Big, Beautiful Bill yet, but there's going to be some kind of reporting on that, so that the overtime premium is not being taxed on a recipient's return.

Eric: So you want to start having in place some kind of tracking methods for what's going to have to be reported, which is going to include what was the pay, what was overtime, and what was the overtime premium that was paid. And this will probably end up on a W2 form. So just like an employer sends a W2 now and has all this required information in it, this will be additional required information that will go on an employee's W2. So there's the new overtime rules that HR managers might want to be paying attention to, especially manufacturing, where there is a lot, typically, a lot of hourly wages and overtime pay.

Eric: The other thing is looking at tax benefits that are out there that might provide benefits that are, we'll call, unique and special to your firm, that stay, keep workers attracted. Maybe don't have a large cost to them for the employer, but if you offer them, it again, offers more attachment to the employees. Might have more loyalty one from the employees by offering these. Things like dependent care, tax preferential payments for health insurance, education assistance and adoption.

Those, all those types of things have tax-free ways that employees can contribute to them, that maybe offer employee benefits at a lower cost to the employer, because some of it's really kicked in by the employee. But those become tax-free dollars to the employee if they can get into those kinds of programs.

Eric: So, you're looking for tax benefits that can be offered to the employees that really have low cost to employer, but are a benefit to the employee, because the employee gets to pay for things that they might not otherwise get to pay with tax, pre-tax dollars.

Lee: Great. So a lot of tax things that HR managers should be thinking about. Eric, you're a tax guy. You've got your masters in taxation. You talk tax every day, but…

Eric: Pretty much.

Lee: Sometimes we got to take off that, sometimes we got to take off that hat. And we actually had a conversation with our HR director to ask her the same question. What, what did she say? She had a little bit of a different take.

Eric: She did. She did, I mean, it was surprisingly human. So what she said was, hey, you know what you really should pay attention to from an HR side, aside from all this tax stuff, is go out and walk the floor, get to know your employees, and get to understand, you know, what their needs and concerns are. So she came in it from a standpoint of just making sure that, are the employees being taken care of here? Are they, you know, respecting of management? Do they respect the company, you know? Do you have good attitudes among those employees on the floor, you know? And you know, if not, that can be an early indication of problems that eventually could affect the bottom line of your company. Now, I'll add that she didn't say anything about the bottom line, but I'll add that those kinds of things can fester and affect the bottom line of your company. So you want to be out and make sure your employees are taken care of. So her advice was, walk the floor, get to know the employees.

Lee: I think that's, it's great. I think coming at that from two different perspectives is a great way to look at it.

Lee: So that wraps up this week's episode of The Biz Beat by SVA. I want to remind everybody, on Tuesday, July 22 at noon central is going to be our live webinar. We're going to have several different SVA folks talking about different aspects of this. We'll talk about what the previous legislation was, what the changes are, and then what you need to be thinking about as a business owner moving forward.

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