Steve Leimberg's Income Tax Planning
Email Newsletter Archive Message #132

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Subject: Nathan Perlmutter & Michael Geeraerts - Tax-Deductible Qualified Plan Contributions May Help Business Owners Qualify for the New 20% Qualified Business Income Deduction

"The Tax Cuts and Jobs Act (TCJA) added IRC 199A to our tax code, which is a tax deduction for business owners of "pass-through" entities. Generally, this new deduction allows business owners of pass-through entities to take a deduction of up to 20% of their pass-through profits. However, there are taxable income thresholds that phase-out this deduction, so maximizing a business owner's tax deductions may be important to qualify for this new deduction. Qualified retirement plans can provide a business owner with tax deductions for plan contributions, as well as reduce the business owner's taxable income below the threshold to qualify for the 20% deduction, providing a double benefit of funding a qualified plan."

In their commentary, **Nathan Perlmutter** and **Michael Geeraerts** discuss how small business owners of pass-through entities who are bordering on the threshold of losing out on the IRC 199A deduction can benefit from establishing and funding a qualified retirement plan.

Nathan Perlmutter, CLU®, ChFC®, is the President and Chief Executive Officer of Forest Hills Financial Group, Inc., a General Agency of The Guardian Life Insurance Company of America.[i, ii] The Agency is one of the leading agencies representing Guardian and is presently a charter member of Guardian's Presidents Forum. Nat has served three terms as Chairman of Guardian's prestigious Field Advisory Board, is a past NAIFA (National Association of Insurance and Financial Advisors) Trustee, the Past President of the New York State and New York City Life Underwriters Association, and Past President of AALU (Association for Advanced Life Underwriting).

Michael Geeraerts, CPA, JD, CGMA®, CLU® is an advanced planning consultant at **The Guardian Life Insurance Company of America**.[ii] Prior to joining Guardian, Michael was a manager at PricewaterhouseCoopers LLP and a tax consultant at KPMG LLP. Michael's experiences range from preparing tax returns for middle market companies, auditing billion-dollar mutual funds' financial statements, to researching unique tax savings strategies for various companies. Michael has written articles for numerous national publications and has delivered continuing education courses to CPAs and attorneys on a variety of estate, business and income tax planning strategies.

Here is Nat and Michael's commentary:

EXECUTIVE SUMMARY:

President Trump signed the Tax Cuts and Jobs Act (TCJA) into law in December 2017. The TCJA added the qualified business income deduction under IRC 199A, which generally allows business owners of pass-through entities to take a deduction of up to 20% of their pass-through profits. However, there are taxable income thresholds that phase-out this deduction, so maximizing a business owner's tax deductions may be important to qualify for this new deduction. Qualified retirement plans can provide a business owner with tax deductions for plan contributions, as well as reduce the business owner's taxable income below the threshold to qualify for the IRC 199A deduction.

COMMENT:

IRC 199A is a new and complex statute. To simplify it, pass-through business owners who have taxable income below the threshold ($315,000 for married filing joint and $157,500 for single filers), can generally take a 20% deduction of their pass-through income. For example, a sole proprietor who files jointly with a spouse has $100,000 of income from the sole proprietorship and the couple's total combined taxable income is $150,000, so they can take a $20,000 deduction (20% × $100,000), resulting in net taxable income of $130,000. If it were only that simple.

There are phase-outs of the deduction when taxable income is between $315,000 and $415,000 for married filing joint taxpayers and between $157,500 and $207,500 for single taxpayers. More importantly here, once taxable income reaches the $415,000/$207,500 level, there are additional calculations that are performed to determine the final deduction under IRC 199A.

When taxable income reaches the $415,000/$207,500 threshold, for a non-service business the client can generally only take into account under IRC 199A the lesser of **(1)** 20% of qualified business income or **(2)** the greater of (a) 50% of W-2 wages paid to employees or (b) 25% of W-2 wages paid to employees plus 2.5% of the unadjusted basis of qualified property in the business. The final IRC 199A deduction is generally going to be the lesser of **(A)** the taxpayer's combined qualified business income (as computed above), or **(B)** an amount equal to 20% of the excess of the taxpayer's taxable income for the taxable year over the taxpayer's net capital gain. The deduction cannot exceed taxable income reduced by the taxpayer's net capital gain for the taxable year.

For a specified service business, once a client's taxable income reaches the $415,000/$207,500 threshold, there is no deduction at all. A "specified service business" is any business that has income from the following activities: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, any business where the principal asset is the reputation or skill of one or more employees, or any business which involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities. Therefore, managing the taxable income of owners of specified service businesses is critical in being able to claim the new IRC 199A deduction. A qualified retirement plan may be a way to do that.

Service Business Example

A sole proprietor accountant who has no employees has a net profit of $415,000 from his practice. The owner files jointly with a spouse and their taxable income will be exactly $415,000. With taxable income of $415,000, they cannot claim an IRC 199A deduction.

However, if the accountant establishes a defined benefit plan through his practice and if he can make a $100,000 tax-deductible plan contribution, the couple's taxable income will be $315,000, putting them right at the threshold and making the service business income eligible for the IRC 199A deduction. The result would be a $63,000 deduction, which is 20% of their taxable income of $315,000 (not 20% of the business income of $415,000 because the deduction is limited to 20% of the excess of the taxpayer's taxable income for the taxable year over the taxpayer's net capital gain). Here, a $100,000 tax-deductible contribution to a qualified retirement plan reduced taxable income to the threshold, making the couple eligible for a $63,000 IRC 199A deduction.

A new tool developed by Leimberg Information Services can help advisors model how making qualified retirement plan contributions can reduce a client's taxable income and how that impacts the IRC 199A deduction.

Below is a screenshot of the tool and the input screen:

Impact of Qualified Retirement Plan Deduction on IRC 199A Deduction			
Specified Service Trade or Business?	Yes		
Filing Status	Married Filing Joint		
Entity Tax Type	Schedule C		
Qualified Trade or Business Income (Before Qualified Retirement Plan Contributions)	$ 415,000		
Qualified Retirement Plan Contribution (Amount Allocated to Owner)	$ (100,000)		
Qualified Retirement Plan Contribution Deduction (Amount Allocated to Non-Owner Employees)	$ -		
Qualified Trade or Business Income (After Qualified Retirement Plan Contribution Deduction for Business)	$ 415,000		
W-2 Wages Paid to Employees	$ -		
Qualified Property Unadjusted Basis	$ -		
Other Net Taxable Income (Deduction) Reported on Form 1040 Not Already Entered Above	$ -		
Deduction	**With Qualified Plan**	**Without Qualified Plan**	**Difference**
Taxable Income Before Deduction	$ 315,000	$ 415,000	
IRC §199A Deduction	$ 63,000	$ -	
Taxable Income After Deduction	**$ 252,000**	**$ 415,000**	**$ 163,000**
Federal Income Taxes on Taxable Income After Deduction	**$ 49,059**	**$ 96,629**	**$ 47,570**
Federal Income Tax Savings By Having Qualified Plan Less Plan Contributions for Non-Owner Employees	**$ 47,570**		

Conclusion

Advisors to small business owners of pass-through entities who will have taxable income in excess of the threshold for the IRC 199A deduction may want to consider, and model, how a qualified retirement plan may benefit their clients and make them eligible for the IRC 199A deduction.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Nathan Perlmutter
Michael Geeraerts

CITE AS:

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