DANA CONSULTING GROUP

memorandum

Innovative Design and
Administration of Retirement Plans

IRC 199A PASS-THROUGH DEDUCTION & QUALIFIED RETIREMENT PLANS

The Tax Cuts and Jobs Act was enacted on December 22, 2017 that, among other things, created a new section of the Internal Revenue Code called Section 199A that provides for a 20% deduction against an individual's taxable income for income received from pass-through businesses such as sole proprietorships, LLCs, partnerships and Sub S corporations. This firm memorandum explores some of the implications of Section 199A as they relate to qualified retirement plans.

Individual Tax Rates After 2017

Tax Rate	Single Income Over	Married Filing Joint (MFJ) Income Over
22%	$38,700	$77,400
24%	$82,500	$165,000
32%	$157,500	$315,000
35%	$200,000	$400,000
37%	$500,000	$600,000

We start with the new income rates for individuals, starting in 2018. Notice the big jump in tax rates from 24% to 32% once the individual's taxable income goes over the threshold. A married taxpayer making over $315,000 while working may very well receive less than that after retirement, even taking into account distributions he/she may receive from their qualified plans and IRAs. This will affect planning before retirement and how to get the most out of the Section 199A pass-through deduction now.

We will not get into the mechanics of calculating the deduction – it's complicated. For purposes of this firm memorandum, we are going to use a simplified formula.

Where the taxpayer's taxable income does NOT exceed dollar threshold for the 32% tax rate above [i.e., $157,500 (single) or $315,000 (MFJ)], the deduction is equal to 20% of the "qualified business income (QBI)" for the year. Each qualified business is treated separately.

Where the taxpayer's taxable income exceeds the income threshold, the deduction is equal to the lesser of (A) or (B), where

(A) Equals 20% of the "qualified business income (QBI)" for the year, and

(B) Equals the greater of (i) 50% of all W-2 wages paid, or (ii) 25% of the W-2 wages, plus 2.5% of the unadjusted basis of qualifying property.

NOTE: Item (B) relating to wages and property ONLY applies where taxable income exceeds the dollar threshold. Also, there are special rules (see below) for certain personal service businesses.

The deduction calculation is also affected by the taxpayer's capital gains and any REIT income. We ignore that here and focus on the 20% QBI calculation, subject to the limits for W-2 wages.

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Example. Sue is a sole proprietor with annual net earnings from self-employment (NESE) of $100K. She has no employees (so no W- 2 wages paid). Her 199A deduction is $20K (or 20% of $100K). However, she still pays self-employment (SE) tax of $14,222.

If she established a cash balance plan and deducts $100K, her QBI goes to $0 and she loses the 199A deduction. AND she still pays the SE tax of about $14,000. So, the pension contribution cost her $20K and did nothing to reduce her SE tax.

What if she operated the business through a S corporation? Without the pension contribution, the corporation has pass-through income of $100K (no wages paid to shareholder) and her 199A deduction preserved at $20K. However, the IRS requires reasonable compensation to be paid. So if $100K wages are paid to her, QBI is $0 and no 199A deduction. Sue still has taxable income of $100K (based on wages) and a FICA tax that is roughly equal to the SE tax. Without a pension contribution, incorporating does not provide much help. However, we can use prior year wages (or NESE, in this case) to compute pension contributions. We can reduce wages paid and fund the pension. That will still reduce the 199A deduction but that is more than offset by the reduced FICA taxes.

NOTE: For purposes of reasonable compensation with the IRS, pension contributions are counted. So diverting wages to pension contributions works for demonstrating what is reasonable.

TIP: Incorporation and pension contribution can reduce taxes, even if the 199A deduction is lost.

Example: Steve is the sole owner and employee of a S corporation. The corporation pays wages to him of $200K and net income after wages of the corporation (QBI) equals $100K. His taxable income (before 199A deduction) is $300K (MFJ, so under the threshold).

Steve's 199A deduction is $20K (20% x $100K) and his net taxable income is $280K.

Consider a pension contribution of $40K.

QBI equals $60K ($100K less $40K). His 199A deduction is reduced to $12,000 (20% x $60K) and his net taxable income is now $248K. The $40K pension contribution cost him $8K in 199A deduction. Perhaps a lower tax rate in retirement may make this up.

However, if compensation of $200K would be reasonable to the IRS, $160K wages and $40K of pension contribution would also be reasonable to the IRS. So where does that leave us?

QBI is still $100K, so his 199A deduction of $20K is preserved. Net taxable income is $240K and the pension contribution did not reduce the 199A deduction.

Example: Stan is a manufacturer's representative operating as a sole proprietor with no employees. His QBI and taxable income (before 199A deduction) are $1 million. Since his taxable income exceeds the dollar threshold (whether he is single or MFJ), his 199A deduction is the lesser of (A) 20% of QBI ($200K), or (B) the greater of 50% of W-2 wages or 25% of wages, plus 2.5% of qualified property. If he has negligible qualified property, his Item (B) amount is $0 since he paid no wages. So his 199A deduction is $0.

Can we fix this by incorporating Stan's business and paying him some wages? If Stan's new Sub S corporation pays him wages of $285,714, his QBI is now $714,286 ($1 million less $285,714). His 199A deduction becomes the lesser of (A) $142,857 ($714,286 QBI x 20%) or (B) $142,857 ($285,857 W-2 wages x 50%).

Comment: You will notice Items (A) and (B) are equal. This “sweet spot” is 2/7 of QBI to be paid as wages.

The above example assumes $285,714 of compensation is reasonable. What if reasonable compensation could be $400K? In this case, QBI becomes $600K ($1 Million less $400K). His 199A deduction becomes the lesser of (A) $120K ($600K x 20%) or (B) $125K ($400K x 50%).

Continuing with the example, let’s split what was $400K of W-2 wages between $250K wages and $150K pension contribution. Stan’s 199A deduction remains at $120K but his taxable income goes down to $730K ($600K QBI + $250K wages - $120K 199A deduction). Incorporating Stan and setting up a cash balance plan reduced taxable income by $270K.

<u>Specified Service Business (SSB)</u>. For businesses that are SSBs, the 199A deduction is phased out once taxable income exceeds the dollar threshold ($157,500 for single, $315,000 for MFJ). Once the excess taxable income exceeds $50K (single) or $100K (MFJ), the 199A deduction is entirely gone. This is where things can get interesting!!!

<u>Example</u>: Sandra is a CPA and sole shareholder of a S corporation. (CPA firms are SSBs.) She is the only employee of the corporation. Corporation pays wages to her of $250K and net income of the corporation after wages equals $200K (QBI). Her taxable income (before 199A deduction) is $415K. She is MFJ, the phase-out of her 199A deduction is complete and she gets no 199A deduction. Her net taxable income is $415K.

What if she establishes a cash balance plan and contributes $100K?

QBI is now $100K ($200K less $100K pension contribution) and her taxable income (before 199A deduction) is $315K. She is no longer over the income threshold and is entitled to a 199A deduction of $20K ($100K x 20%). Her net taxable income is $295K (315K less $20K). So $100K pension contribution resulted in $120K reduction in taxable income. And that occurs even if her wages remained the same at $250K.

What if she reduced her wages from $250K to $150K to reflect the $100K pension contribution? QBI becomes $300K ($200K increased by reduced $100K wages) but drops to $200K after pension contribution. Taxable income (before 199A deduction) is $315K ($415K less $100K pension contribution). Her 199A deduction is $40K ($200K x 20%) and net taxable income is now $275K (vs $295K by leaving her wages untouched). In this case, $100K pension contribution results in $140K reduction in taxable income.

TIP: Shifting wages to pension contributions can increase the 199A deduction and the pension contribution counts toward what is reasonable compensation.

An SSB is any trade or business involved in performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services including investing and investment management, trading or dealing in securities, partnership interests or commodities. The rules are more complex.

<u>Some Matters to Consider</u>:

1. NESE is generally treated as pass-through income whereas with a S corporation, wages paid to the shareholders are not. Only net S corporation income is pass-through income. There is talk the IRS will impose some kind of reasonable compensation requirement on

self-employed individuals to equalize their treatment with shareholders. This is expected to be covered in regulations the Treasury Department will issue.

2. Retirement plan contributions reduce QBI. Special attention needs to be given how contributions are allocated by partnerships. Many partnerships allocate retirement plan contributions on behalf of partners based on what was actually contributed for them (and not based on their relative partnership interest). This is perfectly legal but needs to be spelled out in the partnership agreement as a special allocation. We would expect the IRS to begin looking at partnerships that make these special allocations to verify they are consistent with the partnership agreements.

3. Continuing with Item #2 above, when allocating retirement plan contributions on behalf of a partner to that partner, contributions to defined contribution plans (like profit sharing and 401(k) plans) are easy. Whatever was actually contributed for the partner is the amount to allocate. Things get a little more complicated for contributions to defined benefit and cash balance plans. The IRS has never expressly said how these contributions should be allocated and the rule has generally been "come up with a reasonable basis." This will continue to be the case (until the IRS says otherwise) but may become a more sensitive issue with introduction of the 199A deduction.

4. Another sticky issue that could get even stickier is the case of partners receiving W-2 wages from their partnerships. The IRS position is that partners are not employees and do not receive W-2 wages. As we looked at above, paying wages can increase (or preserve) the 199A deduction. We could see the IRS start focusing more on these situations, particularly where they impact the 199A deduction.

5. Many partnerships make guaranteed payments to partners, generally to reflect services rendered to the partnership. These guaranteed payments (like wages paid to S corporation shareholders) reduce the partner's share of QBI but (unlike S corporation wages) are NOT W- 2 wages for purposes of the wage base limits under Section 199A. There could be situations where reducing guaranteed payments would increase the 199A deduction, particularly where many partners are receiving guaranteed payments.

6. Reasonable compensation has always been a hot issue with the IRS. We would expect the 199A deduction to attract even greater scrutiny on audits. However, as stated above, contributions to qualified retirement plans are considered compensation when determining what is reasonable.

As the above hopefully demonstrates, there is planning that needs to be done to maximize what 199A deduction may be available. Calculation of the components of the 199A deduction is complicated and we simplified things here to focus on how pension contributions can impact the calculation. We strongly recommend our readers who own pass-through entities to start a discussion with their CPAs. Our firm is always available to add our input into using a qualified plan for effective tax planning. If you would like to discuss your own situation with us, please call Lee T. Jennings at (630) 802-7644.

Please visit our website at www.danaconsulting.com.