The Double Duty Qualified Retirement Plan: Tax-Deductible Contributions May Help Business Owners Qualify for the New 20% Qualified Business Income Deduction

President Trump signed the Tax Cuts and Jobs Act (TCJA) into law in December 2017. The TCJA added the qualified business income deduction, 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 20% 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 thresholds to qualify for the 20% deduction, providing a double benefit of a qualified plan.

The IRC 199A Qualified Business Income Deduction

While this new deduction is quite complex, here are some simplified rules to help understand how it works. If a pass-through business owner has taxable income below the threshold ($315,000 for married filing joint and $157,500 for single filers), he/she can generally take a 20% deduction of his/her pass-through income. For example, if Dave files jointly with his spouse and has $100,000 of income from his sole proprietorship and their total combined taxable income is $150,000, he can take a $20,000 deduction (20% × $100,000), so that his taxable income would be $130,000.

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. But, the important thing to remember here is that once taxable income reaches the $415,000/$207,500 level, there are a new set of rules to follow when calculating the deduction. If a business is a non-service business, then the deduction is generally limited to the greater of (1) 50% of W-2 wages paid to employees or (2) 25% of W-2 wages paid to employees plus 2.5% of the unadjusted basis of certain property in the business.

However, for a specified service business, once a taxpayer's taxable income reaches the $415,000/$207,500 mark, 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. As you can see, this captures a lot of professionals.

Therefore, managing the taxable income of owners of specified services businesses is critical in being able to claim the new 20% qualified business income deduction. And a qualified retirement plan may be a great way to do that.

Service Business Example

Let's look at an example. John is an accountant and operates his practice as a professional limited liability company (PLLC) that is a disregarded tax entity (i.e., files a Schedule C for his business income). John has no employees. As an accountant, John's business is classified as a specified service business. John files jointly with his spouse, Jamie, and their taxable income in 2018 will be exactly $415,000, consisting of $515,000 of net profits from his PLLC and $100,000 of deductions on his Form 1040. With taxable income of $415,000, they cannot claim any qualified business income deduction. If John establishes a qualified retirement plan through his PLLC, and makes a tax-deductible plan contribution of $100,000, the couple's taxable income will be $315,000, putting them right at the threshold and making John's service business income eligible for the 20% deduction, resulting in a deduction of $63,000 (this is 20% of $315,000 of taxable income and not 20% of the business income of $515,000 because that is another limitation under the complex rules). The result here is that a $100,000 tax-deductible contribution to a qualified retirement plan for John reduced taxable income to the threshold, making him eligible for a $63,000 qualified business income deduction – resulting in a double benefit.

Conclusion

If you are a small business owner of a pass-through entity and your taxable income will exceed the threshold for the qualified business income deduction, make sure to consult with your Guardian Financial Representative on how a qualified retirement plan may benefit you and also make you eligible for the qualified business income deduction. And, of course, you need to consult with your accountant on how this new and complex qualified business income deduction works, especially in your situation.

Please consult with your Guardian Financial Representative if you have any questions concerning this document.

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Guardian Financial Representatives may call The Business Resource Center for Advanced Markets, at 1.800.871.7780, Option 3, for additional information.

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