November, 2018

Qualified Retirement Plan Design in the New World

While it may seem like the 2017 tax season just ended, it is already time to begin helping our clients plan for 2018. In the old days (the old days being 2017), planning for the current year would heavily rely on a client's prior year information. However, The Tax Cuts and Jobs Act of 2017 (TCJA) made sweeping changes to the tax code, drastically altering the calculation of our clients' tax liabilities. Whether we are talking about the reduced individual tax rates, the new cap on state and local tax deductions or, for our small business clients, the new Section 199A Qualified Business Income (QBI) deduction, tailor made tax planning has never been more crucial. This article will explore how the right Qualified Retirement Plan design can be an integral part of your clients' overall tax plan.

By now, we all know the benefits of establishing a Qualified Retirement Plan. Plan assets are protected from creditors, with limited exceptions. Plan contributions are tax deductible and grow on a tax-deferred basis within the plan. Many modern plans contain a Roth component, which trades the immediate tax deduction for tax free growth. Companies that establish Qualified Retirement Plans can even use them as an attraction tool and a retention tool, which becomes more and more valuable as our economy nears full employment. While all of these were certainly good reasons to establish a Qualified Retirement Plan in the old days, the following examples will show why it makes even more sense to do so under TCJA. Since the rules surrounding the QBI deduction can get very complicated very quickly, we're going to make two assumptions to try to keep things as simple as possible:

1. The only employee is the 100% owner of the business
2. Any non-business income will be offset by the taxpayer's deductions for the year

Example #1 – Sole Proprietor Specified Service Business

TCJA limits the QBI deduction for taxpayers with Qualified Business Income sourced from a so-called "Specified Service Business*" (SSB) if the taxpayer's taxable income exceeds a certain threshold. That threshold is $315,000 for taxpayers that are married filing jointly and $157,500 for taxpayers that are single or married filing separately. Married taxpayers with taxable income in excess of $415,000 ($207,500 for single taxpayers) are completely excluded from any QBI deduction.

Consider a sole proprietor with $415,000 of net self-employment income sourced from a Specified Service Business. Without any other deduction to reduce the business owner's taxable income, the owner is denied the benefit of the QBI deduction. If the business owner establishes a Qualified Retirement Plan (specifically a Defined Benefit Plan), the deductible contribution can reduce the owner's taxable income down below the threshold.

		No Qualified Plan	Qualified Plan
A	Net Schedule C Income	$415,000	$415,000
B	Defined Benefit Contribution	N/A	$100,000
C	Net Taxable Income (Before QBI Deduction) (A – B)	$415,000	$315,000
D	QBI Deduction (C x 20%)	DISALLOWED	$63,000
E	Net Taxable Income (After QBI Deduction) (C – D)	$415,000	$252,000

In this case, by contributing $100,000 to a Qualified Retirement Plan, the business owner reduces the owner's taxable income by $163,000. While this may not do the trick for business owners making several million dollars per year, it will work like a charm for those in the $400,000 to $600,000 range.

Example #2 – SEP vs. Qualified Plan for an S-Corp

Consider the owner of a small S-Corporation who has been maximizing his/her SEP contribution for the last few years. The maximum contribution is 25% of compensation, up to the annual IRS limit ($55,000 for 2018). Since the employer is an S-Corp, compensation only considers the owner's W-2 wages for this purpose. So the business owner's W-2 wages need to be at least 4 times the amount of the SEP contribution. In our example, that would give us minimum W-2 wages of $220,000 to achieve a $55,000 contribution (4 x $55,000).

Let's say that business owner decided to contribute $55,000 to a Qualified Retirement Plan instead (specifically a Profit Sharing Plan with a 401(k) component). The first $18,500 would be deducted through payroll as the business owner's 401(k) contribution, so it does not count towards the 25% limit. The owner's W-2 wages would then only need to be $146,000 to achieve the remaining $36,500 contribution (4 x $36,500). Reducing the business owner's W-2 wages by $74,000 ($220,000 - $146,000) creates a Medicare tax savings of roughly $2,000. Big deal. But let's look at it in the context of TCJA, specifically the QBI deduction.

		SEP	Qualified Plan
A	Business Income	$370,000	$370,000
B	Shareholder Wages (W-2)	$220,000	$146,000
C	401(k) Deferral (Deducted From W-2 Wages)	N/A	$18,500
D	Employer Contribution	$55,000	$36,500
E	S-Corp Distribution (K-1) (A – B – D)	$95,000	$187,500
F	Net Taxable Income (Before QBI Deduction) (B – C + E)	$315,000	$315,000
G	QBI Deduction (E x 20%)	$19,000	$37,500
H	Net Taxable Income (After QBI Deduction) (F – G)	$296,000	$277,500

In the above illustration, making this change from a SEP to a Qualified Retirement Plan almost double's the business owner's QBI deduction. If the business owner is age 50 or older, an additional $6,000 401(k) catch-up contribution can be added in as well, bringing the owner's total contribution to $61,000. The $6,000 catch-up contribution is not available through a SEP.

Example #3 – Tax Free Savings

While many of our clients are still looking for tax-deferred savings vehicles, some clients may be looking at TCJA with the idea that their tax rate will never as low as it is now. This is likely due to the combination of the QBI deduction and the lower individual tax rates. In these cases, it may make sense for that business owner to forego the up-front tax deduction and instead make a Roth 401(k) contribution. Even though the business owner loses the up-front deduction, he/she gets to enjoy the benefits of tax free growth on the accumulated balance. In addition to the Roth 401(k) contribution of $18,500 ($24,500 if the business owner is age 50 or older by December 31), the plan could allow an additional Voluntary After-Tax contribution of $36,500. Voluntary After-Tax contributions are normally subject to <u>tax-deferred</u> growth within the plan, but can begin to accumulate on a <u>tax free</u> basis if the funds are transferred out of the plan to a Roth IRA. This type of design would give a business owner $55,000 ($61,000 if the business owner is age 50 or older) of annual savings that grows tax free. While these business owners would normally be restricted from contributing to a Roth IRA as high earners, there are NO income restrictions on these features in a Qualified Retirement Plan and NO income restriction on the transfer out to a Roth IRA.

Conclusion

Tax-incentivized savings have been the best way for business owners to save for more than 50 years. Business owners can optimize their QBI savings with the right Qualified Retirement Plan design, gaining immediate dollars in their pocket while making tax-deductible contributions. Business owners can also forego the immediate deduction in favor of tax free growth through the combination of Roth contributions and Voluntary After-Tax contributions. The point is, even with the tax code changes under TCJA, the best way for business owners to save is still through a Qualified Retirement Plan.

In order to be effective for the 2018 tax year, Qualified Retirement Plans must be established by **December 31, 2018**. Please feel free to contact our office if you think a Qualified Retirement Plan would be a good fit for one or more of your clients.

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* Any business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, or that consist of investing, investment management, trading or dealing in securities.

Note: Architects and Engineers are specifically excluded from classification as specified service businesses.

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