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Using A Qualified Retirement Plan To Maximize Your "Qualified Business Income" Deduction Under the New Tax Law

In late December 2017, the Tax Cuts and Jobs Act (TCJA) was signed into law. The TCJA makes the most sweeping changes to the Internal Revenue Code in a generation. One significant change, and the subject of this Client Alert, is the addition of a potentially valuable new tax deduction for business owners of so called "pass-through" entities (Sole Proprietorships, Partnerships, Subchapter S Corporations and LLCs taxed as any of the foregoing).

Generally, the new Qualified Business Income (QBI) deduction (Internal Revenue Code Section 199A) allows business owners of pass-through entities to reduce their taxable income by up to 20% of the entity's profits. However, there is a catch: owners of ***Service Businesses**** do not benefit from this deduction if their taxable income exceeds a certain threshold. Specifically, an owner of a Service Business receives only a partial deduction if the owner's taxable income exceeds $315,000 but is less than $415,000 ($157,500 and $207,500 if single), and receives no deduction if the owner's taxable income is $415,000 ($207,500 if single) or more. Significantly, the owner of a Service Business may use contributions to a tax-qualified retirement plan to reduce his or her taxable income, thereby maximizing the owner's QBI deduction.

Consider the following example of a Sole Proprietor in a Service Business with no employees (we assume for simplicity that any non-business income will be offset by the taxpayer's deductions):

	No Plan Contribution	**Plan Contribution**
Sole Proprietor's Net Business Income	$415,000	$415,000
Contribution to Qualified Plan		100,000
Taxable Income Before QBI Deduction	415,000	315,000
QBI Deduction	DISALLOWED	63,000
Taxable Income	$415,000	$252,000

A $100,000 contribution to a tax-qualified plan reduces this business owner's current taxable income by $163,000. That results in a current federal and state income tax savings totaling $59,240 ($47,570 federal plus $11,670 New York State). Stated differently, under these facts, the qualified plan contribution generates an out-sized income tax shield of nearly 60% ($59,240 / $100,000).

While this example seems straightforward, the QBI deduction rules are complex and results will vary based on each taxpayer's personal circumstances. If you would like to look into increasing your annual qualified plan contributions by enhancing your existing plan or establishing a new plan, please reach out to us. We would be pleased to discuss the particulars with you and your tax or financial advisor.

* Technically, a so-called "specified service trade or business" is 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.

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