PENSION TRENDS

BY INDEPENDENT ACTUARIES, INC.

IndependentActuaries.com

Volume XIX, Issue III

July 2018

New Tax Law and Supercharged Deductions

On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act (TCJA), triggering sweeping changes to the tax landscape for both individuals and business owners beginning in 2018. While there were claims during the development of TCJA that tax forms going forward will be the size of a postcard, any simplifications were ultimately outweighed by new complexities. Of course, at IAI we view financial complexities as opportunities to save our clients money!

Changes under TCJA include:

- Limits on itemized deductions, and an increase in standard deduction levels
- Elimination of personal exemptions
- Changes to tax brackets, and lowering of rates (in general)
- Changes to Alternative Minimum Tax (AMT) exemption amounts
- **Creation of deduction for certain “pass-through” income**

It’s this last one that we’ll focus on in this paper. First, a bit of background. Individuals who receive pass-through income include:

- Sole proprietors
- Sole owners of rental real estate
- Partners in partnerships, or in LLCs taxed as partnerships
- S-Corporation owners

In general, for these individuals TCJA provides for a deduction of up to 20% of qualified business income. However, there are some major caveats attached to the eligibility for this deduction. The rules work differently for Specified Service Businesses (SSBs) and non-SSBs. SSBs are generally those businesses for which the principal asset is the reputation or skill of its owners and/or employees (for example, our firm of actuaries and consultants is an SSB). Engineers and architects are specifically excluded; they’re considered to be non-SSBs, along with businesses for which the principal assets are material goods.

The restrictions for SSBs getting the 20% deduction are relatively straightforward, in that they’re based primarily on the individual’s level of taxable income. SSB taxpayers who are married filing jointly are eligible for the full 20% deduction if their taxable income is less than $315,000. Above that level, the 20% deduction phases out, until it’s completely eliminated if taxable income is $415,000 or higher. For single taxpayers, these income thresholds are ½ of the married thresholds.

For non-SSBs the restrictions are more complex. Like SSBs, those married filing jointly and earning less than $315,000 are eligible for the full 20% deduction.

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However, those making more than that are still potentially eligible for the full deduction, so long as their W-2 wages and/or capital investments in qualified property are high enough. Basically, non-SSBs at very high income levels have more opportunities to get the deduction than do SSBs.

There are other potential limitations on the amount of deduction, but they go beyond the scope of this paper.

So, why is a pension plan actuary spending all this time talking about a complex tax issue? **Because in the right situation contributions to pension plans can provide a supercharged deduction that wasn't available under tax law prior to 2018.**

Take, for example, the case of a sole proprietor, age 61, who is a personal wealth advisor (in other words, is considered an SSB). She has $550,000 of business income in 2018, and is married with no dependent children.

Prior to the changes brought about by TCJA, this individual's tax bill would have been about $133,000 in 2018. The tax changes help her a bit: under TCJA, her taxes are only about $120,000. However, she's over the $415,000 upper end of the compensation threshold, so is ineligible for the pass-through income deduction.

We want to do better than this, so suggest that she adopt a defined benefit pension plan in 2018, allowing her to make $250,000 annual contributions towards her retirement benefit. Note that contributions of this level are possible with the right kind of plan design, given her age and income level.

The contribution in 2018 has a twofold effect:

- Like any contribution to a qualified retirement plan, the $250,000 is deductible from taxable income.
- Since it's deductible from taxable income, her $550,000 of business income drops to $300,000 (i.e. - under the lower end of the compensation threshold), making her eligible for the full 20% pass-through income deduction.

In the end, contributing $250,000 to the pension plan lowers her tax bill all the way down to $33,000. Pretty great result!

We'll note that the dynamics under TCJA are exceedingly complex, and that the details of the new law are currently being hashed out by the IRS (they're promising clarification within the next few months). Every situation is different, and a potential pension plan contribution should be considered as just one part of a comprehensive tax strategy.

For a more comprehensive discussion of this topic and of other TCJA changes, the overview of a presentation that we recently co-hosted is available on our website.

If you are interested in exploring whether a qualified plan makes sense for your business, please contact us at 503-520-0848 or at www.independentactuaries.com/contact.

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