Taking Full Advantage of Section 199A

How Retirement Plan Contributions Can Lead to Supercharged Deductions

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- Important caveat

  While we have made a good-faith effort to interpret the dynamics of the new Tax Cuts and Jobs Act, many details about the emerging legislation continue to evolve. The ongoing resolution of those details by the IRS could significantly impact the conclusions and results shown in this presentation.

Goals for Today

- Get a high-level overview of Code Section 199A
- Discuss pension plan contribution limits
- Learn how pension contributions can allow for supercharged deductions
- Work through several examples
- Finish in 75 minutes

Major Tax Reform Changes for Individuals and Business Owners

- Key Business Changes:
  - C Corp tax rate decrease from 34% to 21%
  - 100% bonus depreciation on new and used property
  - Cash method of accounting allowed for all businesses with less than $25M of gross receipts
  - No deduction for entertainment expenses
  - Interest expense limitation at 30% of Tax EBIDTA (N/A for businesses with less than $25M of gross receipts)

Major Tax Reform Changes for Individuals and Business Owners

- Key Individual Changes:
  - Limits on itemized deductions, and increase in standard deduction levels
  - Elimination of personal exemptions, and increase to child tax credits
  - Change of tax brackets, and lowering of rates (in general)
  - Changes to AMT exemption amounts
  - **Creation of deduction for certain pass-through income (Code Section 199A)**

Code Section 199A

- Impacts “pass-through” entities (i.e. – not C Corps)
  - Sole proprietorships
  - Sole owners (or TIC owners) of rental real estate
  - Partnerships (including LLCs taxed as partnerships)
  - S-Corporation owners

Code Section 199A (cont.)

- Provides for deduction of up to 20% of qualified business income (QBI)
  - Limited for both Specified Service Businesses (SSBs) and non-SSBs, but there are different limitations to consider for each
  - Limited by the business owner’s taxable income minus capital gain income

Code Section 199A (cont.)

- Rules work differently for SSBs than for non-SSBs
  - SSBs are generally those businesses for which the principal asset is the reputation or skill of its owners and/or employees
    - E.g. – Health care professionals, attorneys, accountants, consultants, brokers, investment professionals, athletes, performers, etc.
  - Engineers and architects specifically excluded

Code Section 199A (cont.)

- Income-based restrictions

	Non-SSBs	SSBs
Taxable income less than $315,000 (MFJ)	20% deduction	20% deduction
Taxable income between $315,000 and $415,000 (MFJ)	Limitation phased-in	Deduction phased-out
Taxable income greater than $415,000 (MFJ)	Wage/Capital testing	No deduction

- For Single filers, $315,000 and $415,000 are replaced with $157,500 and $207,500, respectively

Code Section 199A (cont.)

- For non-SSBs, there are additional items to consider beyond the income-based restrictions
  - Wage-Capital Factor (WCF) equals the greater of
    - 50% of W-2 income
    - 25% of W-2 income plus 2.5% of capital investments
  - For non-SSBs, the WCF essentially gets compared to the QBI Amount for that trade or business for purposes of the 199A calculations

Code Section 199A (cont.)

- The deduction also can't exceed the lesser of
  - The "Combined QBI Amount", or
  - 20% x (total taxable income – capital gain)
- Combined QBI Amount = Deduction for each qualified trade or business, plus 20% of REIT dividends and PTP income

Examples

- Combined QBI exceeds taxable income
  - Fred is a married real estate investor, who is a 50% partner in a business that earned $500,000
    - Note – Partners and S-corp owners are allocated their proportionate share of the business taxable income
  - His "Combined QBI Amount" ($250,000 x 20%) is $50,000
  - However, due to non-business losses and itemized deductions, his taxable income is only $200,000
  - Fred's 199A deduction is equal to $40,000 (the lesser of $50,000, or $200,000 x 20%)

Examples (cont.)

- Non-SSB not limited by the wage test
  - Sally owns a cleaning company and has overall taxable income of $500,000
  - The cleaning company
    - Generates $100,000 of Business Income
    - Pays W-2 wages of $50,000
    - Has little Qualified Property
  - Sally's 199A deduction equals $100,000 x 20% = $20,000
  - Not limited by the wage test, since $50,000 x 50% = $25,000

Examples (cont.)

- Avoiding limitations using Qualified Property
  - Jim and Nancy own an apartment building in a partnership
    - Rental activity in the building generates $100,000 of QBI
    - Property is not fully depreciated and was purchased for $1M (not including land)
    - No employees
    - The owners take an active role in the operations, treated as a trade or business rather than as a passive investment
  - 199A deduction equals lesser of
    - $100,000 x 20% = $20,000, or
    - The greater of
      - $0 W-2 wages x 50%, or
      - $25,000 [($0 W-2 wages x 25%) + ($1,000,000 property x 2.5%)]
      - =$25,000
  - Business entitled to the full deduction of $20,000

Examples (cont.)

- Phaseout Formula for SSBs
  - Dr. Jane and her husband run a small clinic
    - Taxed as S-Corp
    - Expect \$75,000 of QBI in 2018
    - Expect between \$325,000 and \$375,000 of taxable income in 2018
  - Range of 199A deduction
    - \$75,000 x 20% x {1 – [(\$325,000 - \$315,000)/\$100,000]}

      = \$15,000 x (1 – \$10,000/\$100,000)

      = \$15,000 x 90%

      = **\$13,500**
    - \$75,000 x 20% x {1 – [(\$375,000 - \$315,000)/\$100,000]}

      = \$15,000 x (1 – \$60,000/\$100,000)

      = \$15,000 x 40%

      = **\$6,000**

Managing the Limitation

- Excess Income
  - Problem: Taxable income exceeds threshold amount
  - Solution: Reduce income to increase the deduction
  - This is what we'll be focusing on today
- Excess Limitation
  - Problem: Limitation on high earner exceeds 20% x QBI
  - Solution: Decrease wages or unadjusted basis without penalty
- Unused deduction
  - Problem: Limitation on high earner reduces deduction to less than 20% x QBI
  - Solution: Increase wages or investments to increase the deduction

Managing the Limitation (cont.)

- The business structure matters
  - Example: Family business with no employees other than family members that co-own the non-SSB
  - Business has no qualified property and $1 million of QBI (all taxable)
  - Might make sense to incorporate and pay wages:

	Sole Prop / Partnership	S-Corp
Qualified Business Income	$1,000,000	$700,000
W-2 Wages	$0	$300,000
199A Deduction	$0	$140,000

Managing the Limitation (cont.)

- General Planning Ideas
  - Reduce taxable income
    - **Retirement plan contributions** (but consider impact on QBI as well)
    - Tax-free bonds
    - Life insurance and annuities
    - Real estate investments
    - Oil and gas investments
    - Charitable gifts (including remainder CRTs)
    - Gifts to taxpayers with lower taxable income (e.g. trusts)

Managing the Limitation (cont.)

- General Planning Ideas (cont.)
  - Increase business income
    - Reduce leverage
    - Purchase leased equipment and real estate (in year 2 and beyond)
      - Opportunity for strategic timing
  - Increase W-2 Wages
    - Make S-election and pay wages
    - Increase employee wages
    - Replace contractors with employees

Managing the Limitation (cont.)

- General Planning Ideas (cont.)
  - Increase qualified property
    - Purchase leased equipment and real estate
  - Spin-out or merge businesses (subject to limitations in the Regulations)
    - Separate Service and non-Service Businesses
    - Spin-out real estate
  - Recapitalize businesses
    - Shift leverage to Service Businesses

Managing the Limitation (cont.)

- Bottom line: **It's complicated**
- Each business situation may be impacted differently, so will likely need a customized solution

DC vs. DB Plans

- It's all in the <u>name</u>
- Defined <u>Contribution</u> plans
  - The contribution is the defined element
    - E.g. – Employer contributes 5% of pay for participants each year
  - Amount of savings at retirement is uncertain
  - E.g. - 401k plans, profit sharing plans, money purchase plans, SEPs, SIMPLEs

DC vs. DB Plans

- Defined <u>Benefit</u> plans
  - The benefit at retirement is the defined element
    - E.g. – Participant will get a benefit equal in value to $800 per month beginning at age 62, payable for life
  - Annual contributions needed to fund that benefit are uncertain

DC vs. DB Plans

- **DC Plan Advantages**
  - Appreciated by employees
  - Easy to understand
  - Extremely flexible; contributions are often discretionary
- **DB Plan Advantages**
  - Substantially higher contribution limits for owners/ executives
  - Current compensation not necessary to make a contribution

DB Hybrid Plans

- DB plans that have certain aspects of a DC plan
  - More predictable contributions and financial reporting
  - Understood and appreciated by employees
  - Higher contribution limits of a DB plan
- Often paired with a DC plan
  - Can keep existing DC plan, if any
  - Adds flexibility
- Examples include
  - Cash balance plans
  - Floor offset arrangements

Maximum Annual Contributions (est.)

2024 Maximums

Age	401(k) Only	401(k) with Profit Sharing	Defined Benefit	Total Maximum
60-65	$ 30,500	$ 76,500	$ 274,000	$ 350,500
55-59	$ 30,500	$ 76,500	$ 215,000	$ 291,500
50-54	$ 30,500	$ 76,500	$ 168,000	$ 244,500
45-49	$ 23,000	$ 69,000	$ 132,000	$ 201,000
40-44	$ 23,000	$ 69,000	$ 103,000	$ 172,000
35-39	$ 23,000	$ 69,000	$ 81,000	$ 150,000
30-34	$ 23,000	$ 69,000	$ 63,000	$ 132,000

- Assuming individual has sufficient income and work history

Supercharged Deduction

- Eligibility for Section 199A deduction based on taxable income (assuming SSB owner)
  - Married filing jointly get full deduction if <$315k taxable income, but no deduction if >= $415k taxable income
  - Pension contributions reduce taxable income
- Example
  - S-corp owner has $500k taxable income
    - Ineligible for Section 199A deduction
  - Add a DB plan allowing for $250k annual contributions
    - Gets deduction for the contribution, as well as full Section 199A deduction
    - Supercharged!

Supercharged Deduction

- Excel Example 1
  - Sole proprietor, age 61, with $550k of business income
  - Married with no dependent children
  - Business considered a SSB

  - Impact of a $250,000 pension contribution:
    - Section 199A deduction increases from $0 to $46,200
    - $87,500 in Federal tax savings under pre-2018 tax law
    - $86,798 in Federal tax savings under new tax law

Supercharged Deduction

- Excel Example 2
  - Same as Example 1, but with $680,000 of business income, and W-2 wages of $300,000 for employees
  - Impact of a $250,000 pension contribution:
    - Section 199A deduction increases from $0 to $46,440
    - $78,953 in Federal tax savings under pre-2018 tax law
    - $101,376 in Federal tax savings under new tax law

Supercharged Deduction

- Excel Example 3
  - Same income as Example 1, but business is not an SSB; instead, it's rental real estate with $3,000,000 of qualified property
  - Impact of a $250,000 pension contribution:
    - Section 199A deduction decreases from $75,000 to $46,200
    - $87,500 in Federal tax savings under pre-2018 tax law
    - $60,548 in Federal tax savings under new tax law
  - There is no "supercharged deduction" in this situation, but making a deductible pension contribution may still make sense ($60k in Federal tax savings)

Supercharged Deduction

- Excel Example 4
  - Same as Example 2, but S-Corp owner is taking $200,000 of the business income as W-2 wages
  - Impact of a $250,000 pension contribution:
    - Section 199A deduction increases from $0 to $24,840
    - $78,953 in Federal tax savings under pre-2018 tax law
    - $94,499 in Federal tax savings under new tax law

Supercharged Deduction

- Excel Example 5
  - Same as Example 4, but S-Corp owner is taking $100,000 of the business income as W-2 wages
  - Impact of a $250,000 pension contribution:
    - Section 199A deduction increases from $0 to $35,640
    - $78,953 in Federal tax savings under pre-2018 tax law
    - $97,955 in Federal tax savings under new tax law

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