

January 2018

## **New Tax Law Impacts Qualified Retirement Plan Incentives for Many Business Owners**

***Retirement plan contributions can help many service business owners take advantage of new lower rates, while the tax incentive for others may be reduced.***

### **Background**

On December 22, 2017, President Trump signed into law H.R.1, the tax reform act, which dramatically changes the tax code as of January 1, 2018. This new law includes a key change to the tax treatment of pass-through entities, creating a greater financial incentive for some service businesses to sponsor a qualified retirement plan. The tax incentive may be reduced for others, although numerous other benefits of sponsoring a workplace retirement plan remain the same.

This information release provides an overview of the changes to pass-through income taxation and an explanation of how the new law affects retirement plan incentives for different types of businesses.

### **Changes to the Taxation of Pass-Through Income**

Sole proprietorships, partnerships, LLCs and S corporations are called “pass-through” entities for tax purposes because their profits are passed through to the owners and taxed at individual rates, rather than corporate rates.

Pass-through income is currently taxed at individual rates as high as 39.6%, the top marginal rate. The new law lowers the top individual rate to 37% and also allows many pass-through business owners to deduct 20% of their business income. As a result, some business owners will see a decrease in the effective tax rate they pay on pass-through income.

However, the new 20% pass-through deduction is subject to a number of limitations and phase-outs, outlined below:

1. The 20% deduction of Qualified Business Income (QBI) cannot exceed 20% of your total taxable income, less net capital gains.
2. The full 20% deduction is available to pass-through businesses only when the owners’ total taxable income does not exceed a “threshold” amount of \$315,000 for joint filers (\$157,500 for single filers). When taxable income exceeds the threshold, the 20% deduction amount may be reduced based on a wage and capital limitation. That limitation

is calculated as follows: the greater of 50% of your share of the W-2 wages paid by your business OR 25% of the W-2 wages plus 2.5% of the capital assets used in the production of income. If the result of that calculation is less than 20% of your QBI, your allowable pass-through deduction is ratably reduced. However, when taxable income exceeds \$415,000 (\$207,500 for single filers), your pass-through deduction cannot exceed the lesser of 20% of QBI, OR the wage and capital limitation described above.

3. Owners of professional services businesses<sup>1</sup> such as medical groups, law firms and consultants will have the 20% deduction phased out when joint total taxable income exceeds \$315,000 (\$157,500 if single). No pass-through deduction at all is allowed for those with total taxable incomes over \$415,000 (\$207,500 if single).

These changes to the treatment of pass-through income are effective for tax years after December 31, 2017.

### **When Might Tax Incentives for Retirement Contributions Be Reduced?**

Qualified retirement plan contributions are deducted against business income, which for some owners will now be taxed at a lower rate than the individual tax rate they might pay when withdrawing from the plan in retirement. For example, a pass-through entity owner with earnings of \$800,000 paying an effective rate of 27.6% on business income might prefer to pay taxes now rather than at an effective rate of 29.5% in retirement.<sup>2</sup>

However, keep in mind that qualified retirement plans have many other benefits, including asset protection, the ability to attract and retain top talent, plus the deductibility of employee contributions and plan-related expenses. In addition, it is impossible to predict what future tax rates will be when withdrawing retirement savings.

### **Qualified Plans Continue to Significantly Benefit Service Businesses**

Since the new 20% pass-through deduction phases out for most professional services firms<sup>1</sup> when the owner's joint income exceeds \$315,000 and is eliminated at incomes above \$415,000, contributions to a qualified plan continue to offer a major financial incentive.

In certain cases, there will be an even greater tax incentive than existed prior to the new law. If contributions to a qualified retirement plan can reduce an owner's total taxable income below the thresholds outlined above, they can take full advantage of the new 20% deduction.

For example: a married shareholder doctor's total taxable income is \$450,000, and by contributing \$135,000 or more to a Cash Balance plan, his or her effective federal tax rate could drop to 19.5%.

- Taxable income (after Cash Balance plan):  $\$315,000 = (\$450,000 - \$135,000)$
- 20% pass-through deduction for \$315,000:  $\$63,000 = (20\% * \$315,000)$
- Final taxable income:  $\$252,000 = (\$315,000 - \$63,000)$
- Tax liability from new tax brackets:  $\$49,059 = (\$28,179 + (\$87,000 * 24\%))$
- Effective tax rate (Tax liability / Taxable income):  $19.5\% = (\$49,059 / \$252,000)$

## **What Are We Doing to Help Our Clients?**

We encourage all our clients to consult with their tax advisors to carefully review the ways in which this complex new law impacts their 2018 tax liability. We are ready and available to discuss the qualified retirement plan implications with our clients and welcome their tax advisors to take part in the discussion. During the next few months, Kravitz Consultants will be reaching out to clients directly impacted by the new tax law to discuss how best to proceed.

We also invite all our clients and their advisors to join Dan Kravitz for an informative webinar at 11 am PST on February 6, 2018 to discuss the new tax law's impact on qualified retirement plans. Please click to register: <https://register.gotowebinar.com/register/3106610018878999043>.

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<sup>1</sup> The new tax law defines "Specified service trade or business" as follows: "Any trade or business involving the performance of services in the fields of health, law, 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 which involves the performance of services that consist of investing and investment management trading, or dealing in securities, partnership interests, or commodities. The definition is modified to exclude engineering and architecture service."

<sup>2</sup> The 27.6% effective tax rate here is based on the following example:  
Net earnings: \$800,000 - \$160,000 pass through deduction = \$640,000  
Tax: \$161,379 + ((\$640,000 - \$600,000) \* 37%) = \$176,179  
Effective Tax Rate: \$176,179 / \$640,000 = 27.6%

Without the pass-through deduction:  
Tax: \$161,379 + ((\$800,000 - \$600,000) \* 37%) = \$235,379  
Effective Tax Rate: \$235,379 / \$800,000 = 29.5%