How the New Tax Law Impacts Qualified Retirement Plans

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Presented by
Dan Kravitz
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Agenda

1. Understanding Tax Deductions
2. Business Structures
3. How the New Rules Work
4. Retirement Plan Case Studies
5. Conclusions & Predictions

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Tax Reform and Retirement Plans

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Understanding the New Tax Law (H.R. 1)

Key change impacting small business owners:

- ✓ Change to tax treatment of pass-through entities: some owners can now deduct up to 20% of their qualified business income (QBI)
- ✓ This 20% deduction is subject to limitations and phase-outs
- ✓ Top marginal individual rate has been lowered from 39.6% to 37%
- ✓ **Result:** many owners will have a lower effective tax rate, which may impact decisions about retirement plan design and contributions

***Note*: we are still waiting on IRS guidance for many unanswered questions**.

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Understanding Tax Deductions

Understanding Tax Deductions

Above the Line Deductions:

The 'gold standard,' the most desirable deduction because it reduces your adjusted gross income (AGI)

- ✓ Cash Balance and other IRS-qualified retirement plan contributions

Below the Line Deductions:

Many limitations, subject to phase-outs

- ✓ Charitable contributions
- ✓ State taxes
- ✓ Property taxes
- ✓ Mortgage interest
- ✓ **New 20% pass-through deduction**

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Understanding Tax Deductions

Another way to think about the new 20% pass-through rule is a *"Between the Lines"* deduction:

- ✓ Does **NOT** reduce your AGI like qualified retirement plan contributions
- ✓ But we **don't** expect you have to itemize it on your taxes in order to take advantage, so it differs from traditional 'below the line' deductions, many of which are also subject to phase-outs and limitations.

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Who qualifies for the 20% deduction?

- ✓ Business owners of pass-through entities in **any** type of profession, who have incomes **below a specified threshold** ($157,500 single filer/$315,000 married filing jointly).
- ✓ Business owners of pass-through entities that are **not** specified services firms but do have incomes **above the threshold.**
  - *However, their deduction is subject to limitations.*

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Who does <u>not</u> qualify for 20% deduction?

- ✓ Business owners of pass-through entities that are "specified service businesses" **and** have taxable income above $207,500 single / $415,000 married filing jointly.
  - ***Represents over 80% of the plan sponsors of Cash Balance plans at our firm***

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Business Structures

Business Structures – Pass Through

In pass-through entities, profits are "passed through" to the owners and taxed at individual rates, rather than at corporate rates. Pass-through structures include:

- ✓ **Sole Proprietorship:** this is the simplest form of business entity, since owners do not file a separate business tax return, they report income and expenses on a regular IRS 1040, Schedule C.
- ✓ **Partnership:** two or more owners form a partnership, filing a business return such as IRS form 1065. Income and losses are 'passed through' to individual partners to be reported on their own individual tax returns.

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Business Structures – Pass Through

Other popular types of pass-through entities include:

- ✓ **S Corporation:** an entity that functions essentially like a C-corp except that tax treatment is like a partnership, with income and losses passed to shareholders who must report that information on individual tax returns

- ✓ **Limited Liability Company (LLC):** a kind of hybrid combining elements of both a corporation and a sole proprietorship/partnership. Owners are not personally liable for debts and liabilities, but the entity has its own tax ID number. Income can be passed-through to partners OR they can choose to be taxed as a corporation.

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Business Structures – Not Pass Through

C Corporation: the most common type of corporation, a fully separate legal entity. Can sell stock and list for public trading. Now eligible for the new 21% corporate tax rate and already has many other tax advantages. Income is taxed on corporate returns (form 1120) but shareholders are taxed individually for dividends and distributions.

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How the New Rules Work

Terminology and Definitions

Service business: H.R. 1 tax bill language defines a *"specified service trade or business"*):



- ✓ "A 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.' "

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Terminology and Definitions

The tax bill's definition of a *"specified service trade or business:"*

- ✓ Also includes performance of services that consist of investing and investment management; trading; or dealing in securities, partnership interests, or commodities.
- ✓ Simple definition: business success depends on *you*, not on the items you produce or sell.
- ✓ Specific exemption for engineers and architects written into bill.

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Terminology and Definitions

Qualified business income (QBI):

- ✓ QBI is defined as the net income from your business, not including "reasonable compensation," or any payments to a owner/partner for services outside his or her capacity as a owner/partner.
  - Excludes guaranteed payments to partners of partnerships
  - Excludes W2 wages for owners of S corporations
- ✓ Basically: ordinary non-investment income, net of ordinary business expenses.
- ✓ QBI is determined per business, not per taxpayer.
- ✓ *Note: the 20% deduction of QBI for pass-through business owners cannot exceed 20% of your total taxable income, less net capital gains.*

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Example of the Pass-Through Deduction

Small engineering firm set up as an S-corp:

Qualified business income	$100,000
W2 wages	$150,000
Owner: Susan, taxable income (married)	$300,000

Is Susan eligible?

- ✓ Exempt service business
- ✓ Taxable income below the $315,000 threshold

YES, Susan qualifies for the deduction

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Calculating the Pass-Through Deduction:

Small engineering firm set up as an S-corp:

Qualified business income	$100,000
W2 wages	$150,000
Owner: Susan, taxable income (married)	$300,000

What is Susan's 20% deduction?

20% of QBI	**$20,000** (20% of $100,000)
20% of taxable income	**$60,000** (20% of $300,000)
20% deduction	**$20,000**

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Terminology and Definitions

Threshold amount:

- ✓ The full 20% deduction is available to pass-through business owners with total taxable income **below a 'threshold amount.'**
- ✓ The threshold is $157,500 for individual taxpayers and $315,000 for married taxpayers filing jointly.
- ✓ For business owners with taxable incomes above the threshold, a **wage and capital limit** applies.
- ✓ However, for "**specified service**" **business** owners with incomes above the threshold, the 20% deduction phases out. After a **phase-out limit**, they are **excluded** from the pass-through deduction entirely.

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Terminology and Definitions

Phase-outs for "specified service companies:"

- ✓ The 20% pass-through deduction is 'phased out,' or proportionately reduced, for business owners with taxable incomes between the threshold amount ($157,500 single filer/$315,000 married) and the phase-out limit.
- ✓ **Phase-out limit**: $207,500 single filer / $415,000 married filing jointly.
- ✓ When taxable incomes are in the phase-out range (between $315,000 - $415,000) the deduction decreases as income increases.
- ✓ When taxable incomes exceed the phase-out limit, the deduction is **eliminated**.

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Terminology and Definitions

Wage and capital limitation:

- ✓ When taxable income exceeds the threshold ($157,500 single filer/$315,000 married), the 20% deduction amount is reduced based on a wage and capital limitation.

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Terminology and Definitions

Wage and capital limitation:

✓ **Wage/capital 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 (“qualified property”).
- ➢ If the result of that calculation is **less** than 20% of your QBI, your allowable pass-through deduction is proportionately reduced.
- ➢ If taxable income exceeds $207,500 (single) or $415,000 (married) your pass-through deduction cannot exceed the **lesser of**:
  - 20% of QBI or
  - the wage and capital limitation

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Terminology and Definitions

Qualified property:

- ✓ Qualified property refers tangible items such as equipment, furniture, computers and vehicles, that are subject to depreciation and are used in generating qualified business income.
- ✓ Must be available for use in your business at the end of the tax year.

Example of the Pass-Through Deduction

S corporation, shoe manufacturer (<u>not</u> a specified service business)

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Example of the Pass-Through Deduction

Shoe manufacturer

Qualified business income	$1,000,000
Wages paid to employees	$700,000
Unadjusted basis in qualified property	$0
Alex: **30%** shareholder (married) taxable income	$500,000

What is Alex's 20% deduction?

Allocable share of QBI	**$300,000** (30% of $1,000,000)
Allocable share of wages	**$210,000** (30% of $700,000)
20% of QBI	**$60,000** (20% of $300,000)
50% of W2	**$105,000** (50% of $210,000)
20% of taxable income	**$100,000** (20% of $500,000)
20% Deduction	**$60,000**

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Example of the Pass-Through Deduction

S Corporation is now a CPA firm. Bob is a 30% shareholder.

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Example of the Pass-Through Deduction

S Corporation is a CPA firm. Bob is a 30% shareholder.

Allocable share of QBI	**$300,000**
Allocable share of wages	**$75,000**
20% of QBI	**$60,000** (20% of $300,000)
50% of W2	**$37,500** (50% of $75,000)
20% of taxable Income	**$100,000** (20% of $500,000)
Taxable income	**$500,000** (Exceeds phase out limit of $415,000)
20% deduction	**$0**

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Retirement Plan Case Studies

Case Study

Typical Small Business – S Corporation

1 Owner		
James Marshall	61	$ 275,000
Subtotals		**$ 275,000**

4 Staff		
Brandon Byrd	41	$ 51,000
Jessica Jensen	34	$ 41,000
Ryan Osler	27	$ 34,000
Jimmy Bond	44	$ 21,000

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Current Plans: Cash Balance & 401(k)

Name	Age	Annual Salary	401(k)	Profit Sharing	Cash Balance		Total Contribution	Tax Savings*
1 Owner								
James Marshall	61	$ 275,000	$ 24,500	$ 14,295	$0 to	$ 268,000	**$ 306,795**	$ 138,058
Subtotals		**$ 275,000**	**$ 24,500**	**$ 14,295**		**$ 268,000**	**$ 306,795**	**$ 138,058**
4 Staff				**7.5% of pay**				
Brandon Byrd	41	$ 51,000		$ 3,825		$ 700	**$ 4,525**	
Jessica Jensen	34	$ 41,000		$ 3,075		$ 700	**$ 3,775**	
Ryan Osler	27	$ 34,000		$ 2,550		$ 700	**$ 3,250**	
Jimmy Bond	44	$ 21,000		$ 1,575		$ 700	**$ 2,275**	
Subtotals		**$ 147,000**		**$ 11,025**		**$ 2,800**	**$ 13,825**	**$ 6,221**
Grand Totals		**$ 422,000**	**$ 24,500**	**$ 25,320**		**$ 270,800**	**$ 320,620**	**$ 144,279**
Percent of Contribution to Owner:							**95.7%**	

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Impact of Tax Reform

Should Dr. Marshall still contribute to the plans?

Medical Practice – S Corp

Total Taxable Income	$650,000
Threshold for full 20% Deduction	$315,000
Phase-out limit at which deduction is eliminated	$415,000

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Impact of Tax Reform

By contributing $335,000 or more to the retirement plans, his effective federal tax rate could drop to 20.1%

Taxable income (after retirement contributions)	**$315,000** = ($650,000 – $335,000)
20% pass-through deduction for $115,000*	**$23,000** = (20% * $115,000)*
Final taxable income	**$292,000** = ($315,000 – $23,000)
Tax liability from new tax brackets	**$58,659** = ($28,179+ ($127,000 * 24%))
Effective tax rate (Tax liability / Taxable income)	**20.1%** = ($58,659 / $292,000)

We are assuming $200,000 of income is W2 wages and $115,000 is Qualified Business Income (QBI).

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Qualified Retirement Plan & 20% Deduction

S Corporation (financial services) – married shareholder

W2 compensation	**$200,000**
QBI	**$300,000**
Taxable income	**$500,000** (exceeds $415,000 limit)
20% Deduction	**$0**

Cash Balance contribution	**$185,000**
Taxable income	**$315,000** ($500,000 - $185,000)
QBI	**$115,000** ($300,000 - $185,000)
20% Deduction increases to	**$23,000** (20% of $115,000)
Net taxable income	***$292,000*** *($315,000 - $23,000)*

$185,000 contribution creates $208,000 reduction in taxable income

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When Might Tax Incentives for Retirement Contributions Be Reduced?

- ✓ Qualified retirement plan contributions are deducted against business income
- ✓ Some owners may be taxed at a **lower rate** than the individual tax rate they might pay when withdrawing in retirement
- ✓ The 20% deduction is not available to business income deferred in a qualified plan
- ✓ Plan vs. No Plan: Tax deferral vs. 20% deduction
  - Many variables
  - Plan often wins

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Qualified Retirement Plan & 20% Deduction

Maria: 100% owner-only S Corporation (no qualified plan)

Taxable income	**$275,000**
QBI	**$150,000**
Maria's W2 Wages	**$100,000**
Misc. income	**$25,000**
20% Deduction	**$30,000** (20% of $150,000)
Net taxable income	***$245,000*** *($275,000-$30,000)*

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Qualified Retirement Plan & 20% Deduction

Adopts Profit Sharing and/or Cash Balance Plan

Plan Contribution	**$60,000**
Taxable income	**$215,000** ($275,000 - $60,000)
QBI	**$90,000** ($150,000 - $60,000)
20% Deduction	**$18,000** (20% of $90,000)
Net taxable income	**$197,000** ($215,000 - $18,000)

Taxable Income: $245,000 without plan vs. $197,000 with plan

- ✓ **$48,000 reduction in taxable income** ($245,000 - $197,000)
- ✓ $60,000 contribution when taxed at withdrawal **does not** get 20% deduction
- ✓ Plan contribution is **80% deductible** ($48,000 / $60,000)
  - *However, $60,000 will grow tax-deferred in a qualified plan*
  - *Plan vs. No Plan analysis*

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Conclusions & Predictions

Conclusions

Key incentives for sponsoring an IRS-qualified retirement plan have *not* changed:

1. Accelerate tax-deferred retirement savings
2. Protect financial assets in the event of lawsuit or bankruptcy
3. Attract and retain top talent in a competitive labor market
4. Deductibility of employee contributions and plan-related expenses
5. Strengthen financial wellness benefits for employees
6. Forced savings for the business owner

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Conclusions

Changes to tax incentives are minimal for most business owners with the following exceptions:

1. <u>Non</u>-service pass-through entities
2. Service pass-through entities below the threshold

Reminder: *it is impossible to predict future tax rates, and unwise to base retirement savings decisions on assumptions about your effective rate 20+ years from now. Effective tax rates have changed almost every decade since the 1930s.*

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Predictions

1. Most business owners will continue to adopt qualified plans.
2. Additional analysis will need to take place for some owners:
   - ✓ Opportunity for financial advisors
   - ✓ Partner with tax advisors
3. Could see small reductions to employer contributions:
   - ✓ Some owners might opt for a 401(k) plan only.
4. Qualified retirement plans become even more tax efficient for many service business owners.

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Next Steps

1. Consult with your tax advisor regarding your pass-through deduction eligibility and any changes to your business type.
2. Ask your financial advisor for a plan vs. no-plan comparison.
3. Consult with your Kravitz Consultant on possible changes to your plan design.

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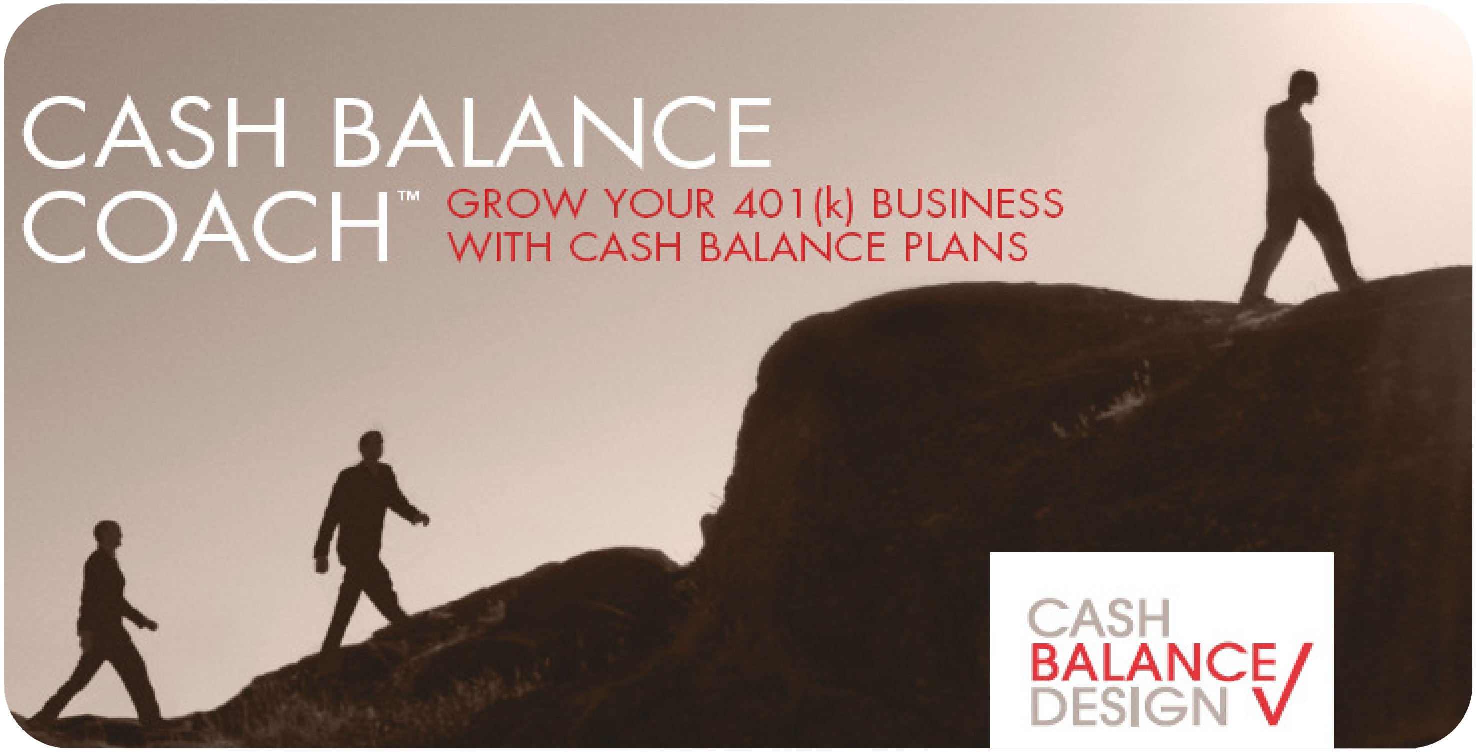
Cash Balance Coach™ Training Program



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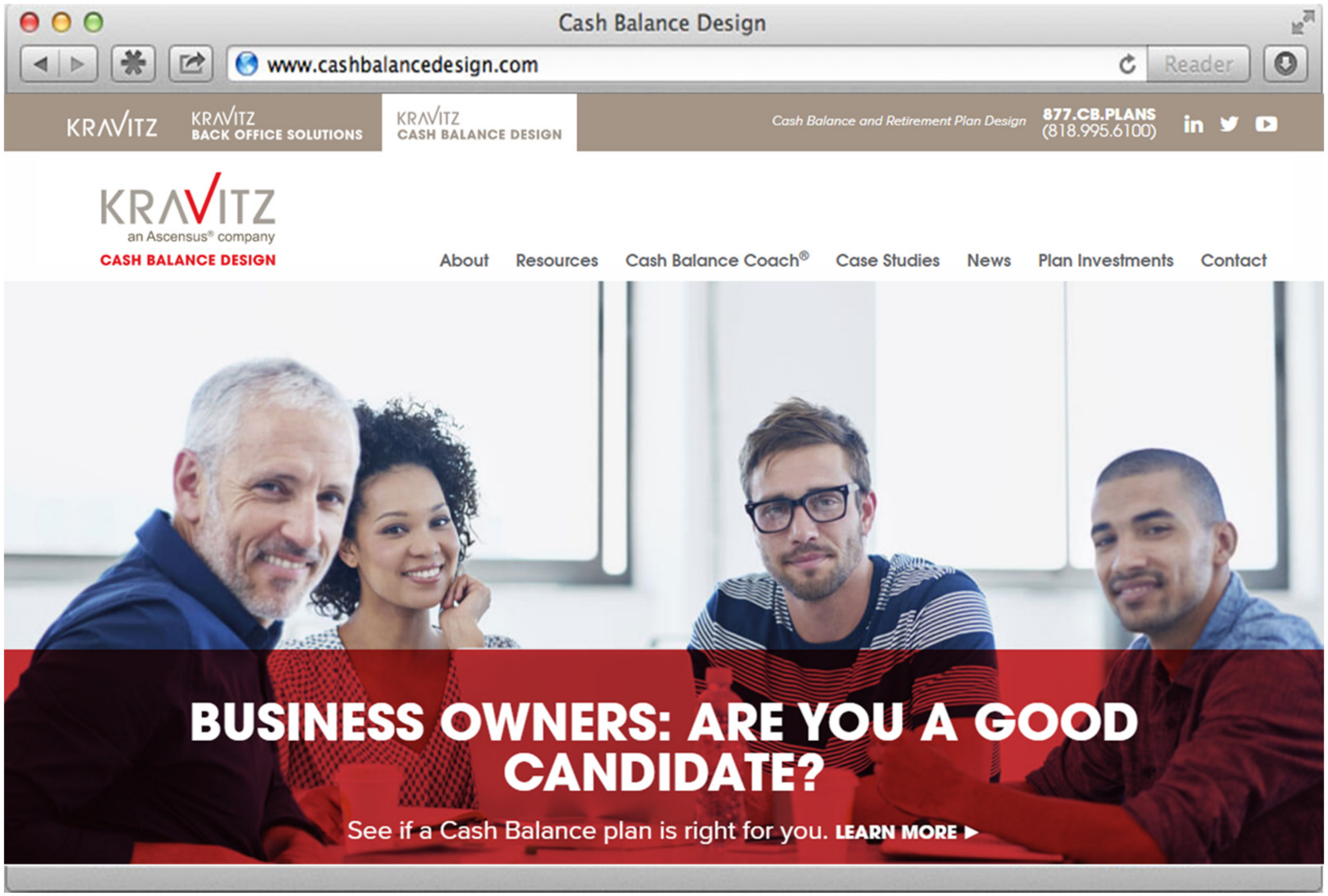
Online Resources: CashBalanceDesign.com 877 CB-Plans



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