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Retirement plan contributions and the owner of a pass-through entity

How does the Qualified Business Income (QBI) deduction impact retirement contribution decisions?

The 2017 Tax Act introduced a new deduction for pass-through business owners (i.e., partnerships, S corporations, and sole proprietorships). Under Section 199A, pass-through business owners might be able to deduct up to 20% of their income generated by the business. The deduction is intended to lower the overall tax on pass-through business income.

Business owners also have the ability to direct pre-tax contributions to qualified retirement plans in which they are participants, such as 401(k) plans or cash balance plans. Business owners can deduct 100% of eligible employee contributions to retirement plans. Further, any employer contributions made to the plans for their benefit are fully deductible by the business itself.

So, how and why do these two tax deduction provisions intersect from a planning perspective?

- **Plan contributions might increase the benefit of the QBI deduction.** If a business owner's taxable income exceeds certain amounts, they might not be able to take full advantage of the QBI deduction. Pre-tax contributions to retirement plans directly reduce taxable income and might enable a business owner to benefit from the QBI deduction.

- **Plan contributions may reduce the amount of QBI eligible for deduction.** Any amounts contributed to a retirement plan by the business as an employer or by a self-employed business owner reduce the amount of QBI eligible for a deduction. The question becomes which is better for the owner: a ***100% tax deferral*** of the amounts contributed to the qualified plan or an ***up to 20% QBI tax deduction*** with respect to those amounts (i.e., a $100 retirement plan deduction reduces the QBI deduction by up to $20).

Retirement plan contributions create opportunity to take or increase QBI deduction

Taxable income plays a large role in applying Section 199A, both in eligibility for the deduction and limitations on the amount deductible. Pre-tax contributions to qualified plans reduce taxable income, which could significantly increase the amount deductible by a business owner.

For service businesses or businesses with few W-2 wage employees or property, it could be critical for taxable income of the owner to be below the threshold amounts to be able to benefit from the deduction.

How the QBI deduction operates

Type of Business (done on a per business basis)	Taxable Income is less than the Threshold Amount	Taxable Income between identified amounts (the Phase-in Range)	Taxable Income is above: Threshold Amount plus $100K if MFJ OR $50K if single
Specified Service Trade or Business	20% of QBI	Phase-out of deduction	$0
Non-Service Business	20% of QBI	Phase-in of wage or property limitation	**Lesser of:** • 20% of QBI OR Greater of • 50% of W-2 Wages • 25% of W-2 Wages plus 2.5% of UBIA[1]
The combined passthrough tax deduction cannot exceed 20% of the taxpayer's Taxable Income			

Threshold Amount	
Filing Status	Tax Year 2019
Single and head of household	$160,700
Married filing joint	$321,450
Married filing separate	$160,725

Example illustrating retirement contribution creating ability to take QBI deduction

Jack & Jill Hill are married and own an S corporation that is considered a specified service business. In 2019, they have $421,000 of taxable income, which consists of:

- Pass-through income from the S corporation of $295,000.
- Compensation of $75,000 from the S corporation to each of Jack and Jill.
- Standard deduction of $24,000.

Item	No contribution	With Contribution
Contribution to Cash Balance Plan	$ -	$ (100,000)
S Corp Income	$ 295,000	$ 195,000
W-2 Wages	$ 150,000	$ 150,000
QBI Deduction	$ -	$ (39,000)
Standard Deduction	$ (24,000)	$ (24,000)
Taxable Income	$ 421,000	$ 282,000
Total Tax	**$ 97,737**	**$ 56,029**

[1] Treas. Reg. §1.199A-1(b)(15) ("unadjusted basis immediately after acquisition (UBIA) of qualified property").

By contributing $100K to a retirement plan, the taxpayer now is eligible to take the QBI deduction and coupled with the retirement plan deduction saves over $40,000 in taxes today. The $100,000 contribution will grow tax-deferred in the retirement plan account.

Retirement plan contributions reduce the QBI deduction

Pre-tax contributions to retirement plans result in a full exclusion from current income of the amount contributed. Amounts contributed and growth on contributions instead will be taxed when distributed at some point in the future. Once contributed, the amounts grow on a tax-deferred basis.

In comparison, QBI eligible for the 199A deduction results in a current income tax deduction of up to 20%. There is no future taxation on the amount deducted.

Because amounts contributed to a qualified plan reduce the eligible QBI deduction amount, the question needs to be asked as to which is better for the business owner.

A number of factors go into the analysis of whether, and how much of, a contribution to a qualified plan should be made by a business owner whose income qualifies for the QBI deduction.

- **Cash flow requirements.** A contribution to a qualified plan results in a current income tax deduction for the full amount of the contribution, compared to a 20% QBI deduction, thus resulting in more cash in hand today.
- **Anticipated future income tax rates.** If the business owner expects to be taxed on ordinary income at higher rates in the future, then tax deferral may not be as beneficial. However, lower income tax rates in the future would favor tax deferral.
- **Tax on invested assets.** Only proceeds in excess of basis are taxed as capital gain in an after-tax account. Interest and dividends are taxed as ordinary income. In comparison, all distributions from a qualified plan account are taxed as ordinary income.
- **Need to reduce adjusted gross income (AGI) to qualify for other deductions or benefits.** By making a retirement plan contribution, a business owner can lower her AGI and possibly deduct medical expenses, get college tax credits, or reduce the amount of social security benefits that are taxable.

Conclusion

The interaction between the new tax deduction for QBI of pass-through business owners and qualified plan contributions may not be obvious at first. They both generate tax deductions. However, because the QBI deduction is tied so closely to a taxpayer's income (i.e., QBI and taxable income), the impact of retirement plan contributions on income impacts the QBI deduction in ways that may be unexpected. While the same might be able to be said about any deductible expense of a business, only qualified plan contributions represent an opportunity for owners to save for retirement for their own benefit. Business owners will need to consider all the variables and ramifications with their tax advisor to make an informed decision.

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