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REGAINING THE 199A DEDUCTION

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Utilizing a Cash Balance Plan to regain 199A Deduction

The 2017 Tax Cut and Jobs Act (TCJA) increases the value of opening Cash Balance Plans with the added benefit of enabling taxpayers to qualify for the new 20% Section 199A deduction. Taxpayers can gain an additional $30,000 to $60,000 in possible tax deductions with the new regulation.

The Cash Balance Plan (in 100 words or less) – click here for the full report

A Cash Balance Plan is a type of retirement plan that belongs to the same general class of plans known as Qualified Plans. These plans qualify for tax deferral and creditor protection under ERISA. First introduced nearly 40 years ago, Cash Balance Plans were seldom used until specific legal issues were clarified in the 2006 Pension Protection Act, 2010 IRS Cash Balance regulations and 2014 Final IRS Cash Balance regulations. This recent legislation has made these plans even more flexible and easier to administer – making them an increasingly popular choice for successful business owners.

The addition of Section 199A allows for a 20% qualified business income (QBI) tax deduction to pass-through entities such as sole proprietorships, partnerships, LLCs, S Corporations, trusts, estates and certain real estate businesses.

To qualify for the Section 199A deduction, business owners are subject to income-based eligibility requirements. Business owners with high incomes that exceed the thresholds should consider establishing tax-advantaged retirement plans. Maximizing contributions to the plans can provide an opportunity to reduce taxable income to a range where the business owner can take advantage of the 199A deduction.

The below chart illustrates contribution limits for 2019. Adding a Cash Balance Plan to Traditional Qualified Plans would greatly increase the contribution limit

2019 Plan Limits

		401k Profit Sharing Plan			
Age	**Cash Balance**	**Salary Deferrals**	**Profit Sharing**	**Total**	**Total Cash Bal and 401k PSP**
45	$123,000	$19,000	$37,000	$56,000	$179,000
50	$158,000	$25,000	$37,000	$62,000	$220,000
55	$203,000	$25,000	$37,000	$62,000	$265,000
60	$261,000	$25,000	$37,000	$62,000	$323,000
65	$271,000	$25,000	$37,000	$62,000	$333,000
70	$336,000	$25,000	$37,000	$62,000	$398,000

Note: The chart shows the limits of stand-alone plans and the total if combined. Maximum contribution levels are attained by using both Cash Balance Plans and 401k Profit Sharing Plans.

Limits

The Section 199A deduction is applied and calculated differently depending on whether the business is considered a Specified Service Business or a Qualified Business.

Specified service trade or business (SSTB), includes a trade or business in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, investing and investment management, trading, dealing in certain assets or any trade or business where the principal asset is the reputation or skill of one or more of its employees.

A Qualified trade or business is any trade or business, not mentioned above as a Specified Service Trade or Business.

For Specified Service Businesses, the deduction begins phasing out for single and joint filers at $157,500 and $315,000 of taxable income; and is completely eliminated after $207,500 and $415,000 of taxable income. For Qualified Businesses, the phase out begins at the same levels, but is limited, not eliminated at the upper threshold.

The chart below outlines the rules, but the key takeaway is the value in lowering taxable income below the $157,500 (single taxpayer) or $315,000 (married taxpayers) thresholds if at all possible.

Single Taxpayer	**<$157,500**	**$157,500- $207,500 (Phaseout Range)**	**>$207,500**
Specified Service Business	Qualifies for full deduction	QBI is reduced by the proportion of taxable income within the phaseout range. The 20% deduction is applied to the new QBI but then limited to the greater of 50% of proportionally reduced W-2 wages paid by biz or to 25% of W-2 wages paid + 2.5% of proportionally reduced assets' cost.	No Deduction
Qualified Businesses	Qualifies for full deduction	The 20% deduction on QBI is limited to the greater of 50% of W-2 wages paid by biz or to 25% of W-2 wages paid + 2.5% of original assets' cost. However, the wage limit is gradually applied within the phaseout range.	The 20% deduction on QBI is limited to the greater of 50% of W-2 wages paid by biz, or to 25% of W-2 wages paid + 2.5% of original assets' cost.
Married Filing Jointly	**< $315,000**	**$315,000 - $415,000 (Phaseout Range)**	**>$415,000**
Specified Service Business	Qualifies for full deduction	QBI is reduced by the proportion of taxable income within the phaseout range. The 20% deduction is applied to the new QBI but then limited to the greater of 50% of proportionally reduced W-2 wages paid by the biz, or to 25% of W-2 wages paid + 2.5% of proportionally reduced assets' cost.	No Deduction
Qualified Businesses	Qualifies for full deduction	The 20% deduction on QBI is limited to the greater of 50% of W-2 wages paid by biz or to 25% of W-2 wages paid + 2.5% of original assets' cost. However, the wage limit is gradually applied within the phaseout range.	The 20% deduction on QBI is limited to the greater of 50% of W-2 wages paid by biz, or to 25% of W-2 wages paid + 2.5% of original assets' cost.

Using Cash Balance Plans to get more high earning business owners under the income-based threshold of 199A

The immediate benefit of a qualified plan contribution is a deduction against taxable income, placing the business owner in a lower tax bracket. In the right circumstances, an effective re-categorization into a lower income level, where some (or all) of the 20% deduction against QBI becomes available.

Cash Balance Plans prove extremely valuable when it comes to maximizing tax and retirement savings under TCJA. They allow for a large contribution allowance, specifically designed for small business owners and the self-employed to put away money for retirement.

With Cash Balance Plans, a taxpayer with enough income and at the right age, can fund a plan annually and deduct as high as $120,000 to $330,000 a year (aside from other contributions to 401k and Profit Sharing Plans).

Cash Balance Plans may potentially allow more high earning business owners to qualify for the deduction that they otherwise wouldn't due to income restrictions. Therefore, the impact is potentially far greater than with IRAs, Sep IRAs, and 401k Profit Sharing Plans.

Examples to illustrate the benefit of lowering taxable income to qualify for all or a portion of the 20% deduction

Example 1: A 401k Profit Sharing contribution lowers total taxable income into the phase out range for a partial deduction, but a Cash Balance would re-characterize the income for a full deduction.

50-year-old, sole owner and employee of an S-Corporation. It is a specified service business and the owner files as an individual. The owner has total taxable income of $250,000. Since the taxable income in this example exceeds the $207,500 threshold, the owner will not be able to take the 20% deduction.

A popular retirement strategy, 401k Profit Sharing Plan, can be utilized to help the business owner get under the $207,500 threshold and into the phaseout level for a partial deduction. The phase out is complex and client will receive direction from his CPA on the eligible portion. Defined Contribution Plans have an upper annual contribution limit of $56,000 ($62,000 with the 401(k) catch-up for those 50 and older). Note: IRAs and SEPs have significantly lower contribution levels.

The owner therefore, may want to consider a larger contribution with a Cash Balance Plan that could lower taxable income to a level that allows for a full Section 199A deduction.

Example 2: Large Cash Balance Deduction to lower taxable income to full deduction

60-year-old married doctor with a practice earning $600,000 a year could set up a Cash Balance Plan to get his taxable income under the $315,000 threshold. He could put $323,000 into a Cash Balance Plan.

The doctor would combine the Cash Balance Plan and 401k Profit Sharing Plan for maximum effectiveness. This combination helps high earning business owners take the largest deductions, and in this example qualify for the 199A deduction.

Conclusion

Business owners in search of tax and retirement savings efficiency should consider qualified plan contributions to lower their income levels to qualify for the 199A deduction.

A Cash Balance Plan offers a significant opportunity for high earning business owners to make contributions above and beyond stand-alone 401k and profit-sharing limits. Even if the 199A deduction doesn't become available in certain situation; a Cash Balance Plan may be the best path to tax-deferred growth and accumulation for retirement.

In the past, small business owners may have been hesitant to adopt a qualified plan due to perceived cost and complexity. However, as regulations have been clarified, the financial and accounting community has become more efficient at helping business owners utilize Cash Balance Plans. This combined with the significant financial incentives could very well lead to more-and-more business owners to make the move.

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