Using a Qualified Retirement Plan to Take Advantage of TCJA Provisions

A 'Triple Play' of Tax Benefits

By David I. Gensler and David M. Gelman

It is way too early to understand the full impact of the Tax Cuts and Jobs Act (TCJA) recently passed by Congress and signed into law by President Trump. Some things, however, are known:

■ Certain specified trades or businesses (e.g., healthcare, the legal field) will not be able to take full advantage of the 20% deduction against pass-through income in section 199A of the Internal Revenue Code (IRC)—also known as qualified business income (QBI) deduction—unless the owners have taxable income below certain thresholds ($157,500 for single filers, $315,000 for married couples filing jointly).

■ The section 199A deduction phases out entirely for QBI for these specified trades or businesses that have taxable income above certain thresholds ($207,500 for single filers and $415,000 for married couples filing jointly).

■ There is a formula to calculate the dollar loss of the phase-out of the section 199A deduction against the QBI between those two income levels.

■ In high-tax states (e.g., New York), federal deductions for state, local, and real estate taxes paid will now be limited to $10,000.

Under the right circumstances, individuals who fall into one of the specified trades or businesses affected by the income levels related to the phaseout of the QBI deduction may be able to utilize qualified retirement plans to provide three different tax benefits, two immediate and one long-term.

Case Study: Two Immediate Benefits

The immediate benefits are as follows:

■ A deduction against taxable income, placing the individual

Exhibit
Effective Income Taxes with and without a Sponsored Defined Benefit Plan

	Without Sponsored Plan	With Sponsored Plan
Taxable Income	$450,000	$450,000
Contribution to Qualified Plan	$0	$150,000
Taxable Income before QBI Deduction	$450,000	$300,000
QBI Deduction	$0	$30,000
Taxable Income	$450,000	$270,000
Estimated Federal & NYS Income Tax	$134,553	$69,925

QBI = Qualified Business Income

in a lower tax bracket.

■ In the right circumstances, an effective recategorization into a lower income level, where some (or all) of the 20% deduction against QBI becomes available.

For the sake of simplicity, the below example only takes into account federal and New York state taxes.

Assume that Jeff is a doctor who is the 100% owner of a medical P.C. organized as a Subchapter S corporation. Jeff has $150,000 of W-2 income and QBI of $300,000, for a total taxable income of $450,000.

The *Exhibit* shows the difference in tax savings. With no retirement plan in place, Jeff's taxable income is greater than $415,000, and he would *not* qualify for the section 199A deduction. He would thus pay $134,553 in federal and state income taxes, an effective tax rate of 29.90%.

If, however, Jeff elects to implement a defined benefit plan with an annual contribution of $150,000, his taxable income would now be lower than $315,000, and the 20% QBI deduction would then be available. He may deduct both the $150,000 contribution and an additional $30,000 against his QBI, thus lowering his federal and state income taxes to $69,925. This represents a tax savings of $64,628, a decrease in his effective tax rate to 15.54%.

The calculation surrounding these sources of income and how much of the 20% deduction against QBI is available to the taxpayer is anything but straightforward.

Case Study: Long-Term Benefit

When distributions begin, since to a very large extent Jeff can control the amount of money he receives from the retirement plan or from his rollover IRA, it is not unreasonable to assume that he will be in a lower tax bracket at that time.

If the $150,000 per annum accumulates at 8% for 10 years, it would grow to approximately $2.2 million. Assuming that tax rates under the 2018 federal and New York income tax tables remain the same during the distribution phase as during the accumulation phase, and assuming that upon retirement, Jeff begins to withdraw approximately 5.5% of the $2.2 million each year (approximately $125,000), plus an additional $75,000 of other taxable income (in total, $200,000 per year), then Jeff would pay approximately $46,000 per year in taxes on the distributions, for an effective tax rate of 23%. This is still well below the 29.9% tax rate Jeff would have paid had he not implemented a defined benefit plan. Of course, if Jeff relocates to a state with no income taxes (e.g., Florida), the results improve even further.

Note that the split between W-2 income and QBI (or guaranteed payments and QBI for LLPs/LLCs) will have a material effect on the section 199A deduction. The calculation surrounding these sources of income and how much of the 20% deduction against QBI is available to the taxpayer is anything but straightforward. How much is allocated to each component of taxable income (W-2/guaranteed payments and QBI) plays an extremely important role in how much of the QBI deduction a taxpayer can recapture. ❑

David I. Gensler, MAAA, MSPA, EA, *is the president of Madison Pension Services Inc., Purchase, N.Y.* ***David M. Gelman, MAAA, MSPA, EA,*** *is the president of Gelman Pension Consulting Inc., New York, N.Y.*