TAX FACTS

Pass-Through Planning to Boost New QBI Deduction Value

Special Content for Financial Advisors and Financial Planners

From the authors and editors of Tax Facts

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TO TODAY'S FINANCIAL ADVISORS AND PLANNERS

The past few months have been a challenging time for many, including financial advisors and planners. Not only did we have a year-end cliffhanger on tax reform legislation, but we finally ended up with one of the most far-reaching tax acts in history. **One of the many changes is the new Pass-Through Deduction for Qualified Business Income (QBI).**

The National Underwriter Company, publisher of ***Tax Facts***, is dedicated to helping financial advisory and planning professionals understand the ramifications of this recent legislation. And I believe this article will give you critical information that will aid in your professional success—helping you be your best when you need it most—with your clients.

Sincerely,
Richard H Cline, J.D.
Sr. Director, Editorial Content
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PASS-THROUGH PLANNING TO BOOST NEW QBI DEDUCTION VALUE

by Robert Bloink, Esq., LL.M. and William H. Byrnes, Edq., LL.M., ®

The new 20 percent deduction for pass-through businesses created a powerful tax reduction tool for clients who operate as partnerships, S corporations or sole proprietorships. Unfortunately, not all business owners are treated equally under the new rules—meaning that higher income clients who own service businesses may need to engage strategies designed to reduce taxable income in order to reap the full benefit of the deduction. For some small business clients, simply maximizing contributions to traditional retirement accounts may be sufficient—but for higher income clients, a multifaceted income reduction strategy will likely be required in order to avoid leaving valuable tax savings on the table.

The New Pass-Through Regime

The 2017 tax reform legislation now allows pass-through entities (such as partnerships, S corporations and sole proprietorships) to deduct 20 percent of "qualified business income" (QBI) (in 2018-2025, unless Congress takes steps to extend the deduction). However, service businesses (including attorneys, accountants, doctors and financial advisors) are not entitled to the full benefit of the 20 percent deduction if the business owner's taxable income exceeds certain threshold amounts.

The applicable threshold levels for 2018 are $315,500 (married filing jointly) or $157,500 (single filers), and the deduction is phased out for service business owners with income between the threshold levels plus $50,000 for individual filers or $100,000 for joint filers. This means that clients who own service businesses and have taxable income that exceeds $415,000 (married filing jointly) or $207,500 (single filers) will not receive the benefit of the new deduction.

For these taxpayers, taking steps to reduce taxable income in order to take advantage of the full 20 percent deduction can lead to significant tax savings.

Income Minimization Tools

The first (and likely most simple) step that small business clients can take to minimize taxable income is to ensure that they are maximizing contributions to retirement accounts. Small business owners can contribute up to $55,000 in 2018 to a 401(k) (including both the employer and employee portion of the

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For clients who need to reduce taxable income by a more substantial amount, however, a cash balance plan may be a more viable solution. A cash balance plan is essentially a cross between a traditional defined benefit pension plan and a defined contribution plan (e.g., a 401(k)). Generally, employers will contribute a set portion of a participant's salary to the plan each year (a "pay credit"; usually equal to between 5 and 8 percent annually), and the participant's account will also be credited with an interest credit each year.

Cash balance plans are technically defined benefit plans, so the annual $55,000 total contribution limit for 401(k) plans does not apply. Instead, the contribution limit for cash balance plans is based on the amount that a participant may receive at retirement (in 2018, a 55 year old may be able to contribute as much as $194,000 to a cash balance plan). An actuary can be used to calculate backward from the benefit amount in order to determine each individual participant's contribution level.

The client is permitted to operate both a 401(k) plan and a cash balance plan at the same time, so that very high income clients can maximize contributions to both types of account.

The cash balance plan contribution will lower the taxable income of the business as a whole (rather than at the individual owner's level, so that the benefit is split among the business owners). However, the business owner will be required to contribute to the accounts of non-highly compensated employees, as well, on an annual basis (meaning that the business owner should ensure that the business has sufficient profits to sustain the cash balance plan over a period of time).

In addition to retirement account planning strategies, small business clients who are charitably inclined should note that the 50 percent AGI limitation on cash contributions to public charities and certain private foundations increased to 60 percent for 2018-2025 (the AGI limit on contributions of capital gains property (such as securities) remained at 30 percent). This basically increases the amount of the contribution that the client will be able to deduct in order to further reduce taxable income.

Conclusion

Clients who operate service businesses and expect to exceed the threshold limits for the new QBI deduction still have time to take steps to reduce taxable income in order to qualify in 2018—a combination of retirement planning and charitable giving can help these clients realize substantial tax savings.

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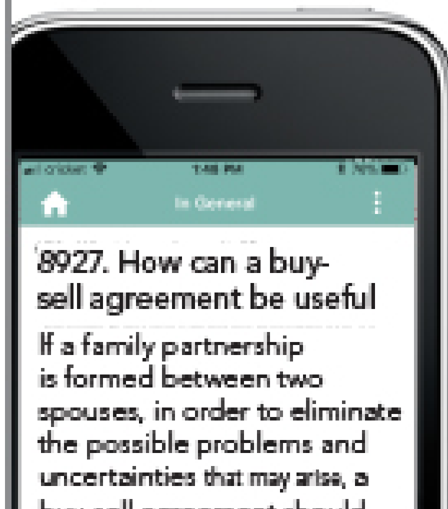

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