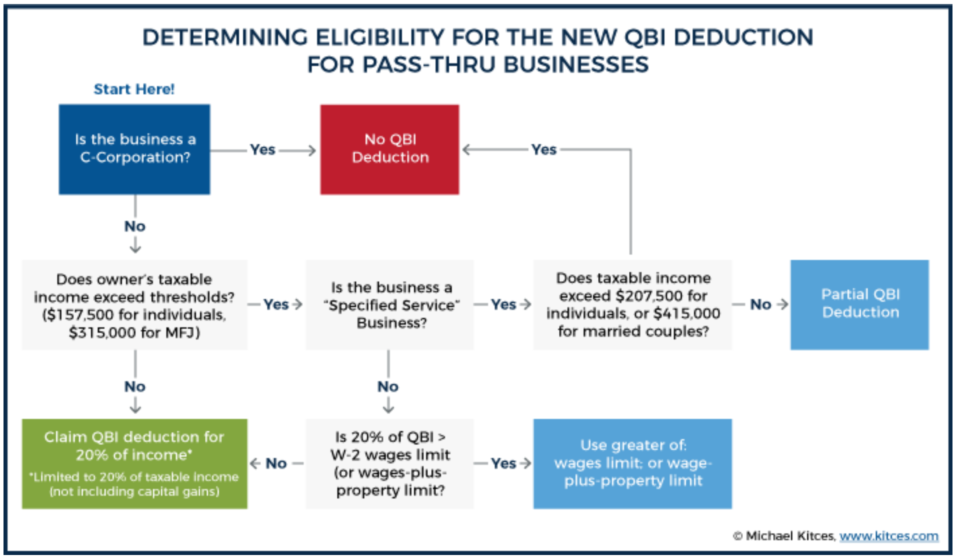
# Section 199A Damages Pre-Tax Retirement Accounts

## Taxes Today by Towerpoint Wealth – 2.11.2019

The IRS has responded to widespread frustration over the lack of clarity regarding how and when a small business owner can take the 20 percent pass-through deduction by releasing the final regulations for Section 199A on January 15.




While a lot can be lost in the shuffle of the 248 page (!) document, one takeaway with critical tax planning implications is this: **the Section 199A deduction will materially reduce the value of tax-deductible retirement plan contributions for many small business owners.**

**Why? Let's look at an example of an S corporation...**

An S corporation's qualified business income (business profit) is reduced by its contribution (i.e. the employer portion) to an employer-sponsored retirement plan, such as a 401(k). Consequently, every employer contribution reduces the income base the 20 percent deduction can be applied to by an equal amount. **Therefore, a pre-tax contribution to an employer-sponsored retirement plan will only result in a <u>partial</u> tax deduction for S corporation owners even when the entire contribution, in addition to all future earnings, will be subject to ordinary income tax upon distribution.**

And while pre-tax retirement plan contributions for partners and sole proprietors do not reduce business profits (they are instead taken as above-the-line deductions on their own individual tax returns), even these owners must "back out" these amounts from business profits before they can apply the 20 percent deduction.

*Important note: business owners in Specified Service Businesses whose income is high enough that the 20 percent deduction is phased out anyway will continue to receive the full benefit of pre-tax contributions.*

TOTAL TAX RATE ON RETIREMENT PLAN CONTRIBUTIONS AFTER QBI DEDUCTION

| Tax Bracket | QBI-Adjusted Value of Retirement Contribution Deduction | Additional Taxes Owed for Deduction-Reduction | Total Tax Rate with QBI Reduction |
|---|---|---|---|
| 10% | 8.0% | 2.0% | 12.0% |
| 12% | 9.6% | 2.4% | 14.4% |
| 22% | 17.6% | 4.4% | 26.4% |
| 24% | 19.2% | 4.8% | 28.8% |
| 32% | 25.6%* | 6.4%* | 38.4%* |
| 35% | 28.0%* | 7.0%* | 42.0%* |
| 37% | 29.6%* | 7.4%* | 44.4%* |

*Assumes a Non-Specified Service Business has enough wages/wages and depreciable property so as to qualify for a full, unreduced, QBI deduction, and that the household's tax rate remains the same throughout.

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**While pre-tax contributions may now be less attractive to some small business owners, we continue to advise our small-business-owning clients that there are still tax advantages to making pre-tax contributions to employer-sponsored retirement plans.**

For example, small business owners will continue to receive at least a partial tax deduction on pre-tax contributions and will experience further the tax-deferred treatment of interest, dividends, and capital gains. This will generally provide a more tax optimal long-term outcome than contributing the same amount to a taxable account.

**More importantly, these final regulations make Roth 401(k)s increasingly attractive compared to pre-tax "regular" 401(k)s.**

**We recommend working with your clients who are small business owners to reevaluate their current company retirement plans. If they do not currently have a Roth 401(k) option available, now is the time to consider adding one.**

Click **HERE** to read a well-written article by Jeffrey Levine of the excellent financial planning blog "Nerd's Eye View" that provides even more detail (and examples) of how Section 199A impacts retirement plan contributions. *(We relied on this article greatly for our explanations above)*

**Turning our attention to the next couple months, the IRS is expected to experience another challenging tax season.** Seven out of eight IRS employees missed 25 days of work during the government shutdown, and the department will continue to play catch-up and scramble to update its systems to meet what was set out under the TCJA.

We recommend clients be aware of the following three issues they may face during the current filing season:

- **Minimal customer service** - hard to imagine it can get much worse but expect an even harder time trying to get an IRS professional on the phone.
- **Slower refunds** - most refunds are done automatically. However, for those returns "flagged," expect longer delays than years past.
- **Technical mishaps** - while the IRS hurries to advance its outdated infrastructure, clients should be prepared for the possibility of another outage.

The article, "*Tax Season Could Be 'Ugly' With IRS Running at Only 57% of Staff*," does a nice job summarizing issues the IRS is already combating for the 2019 tax season.

**Finally, I encourage you to click HERE to read an article on how to optimize the productivity of your practice for 2019.**

## We are here to help.

*As always, please feel free to reach out and call (**916-405-9166**) or email (**spitchford@towerpointwealth.com**) with any questions, thoughts, or needs you may have. At Towerpoint Wealth, we are happy to be a direct and no-strings-attached resource for you.*

*Steve Pitchford CPA, CFP®*
*Director of Tax and Financial Planning*