Tapping the Benefits of 199A with the Help of a Cash Balance Plan

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Section 199A permits owners of pass-through entities to take a deduction on qualified business income ("QBI") from a qualified trade or business. It was enacted into the law in 2017 as part of the Tax Cuts and Jobs Act. However, in the case of an owner of a "specified service, trade or business" ("SSTB"), the deduction is phased out when taxable income reaches a certain threshold. A cash balance plan can be used to prevent loss of the deduction.

Qualified Business Income Deduction

Under Section 199A, owners of pass-through entities like sole proprietorships, S corporations, partnership and limited liability companies may take a 20% deduction on QBI from a qualified trade or business. The QBI deduction is limited to 20% of the taxpayer's taxable income in excess of capital gains. QBI generally means the net amount of items of income, gain, deduction and loss to the extent that those items are effectively connected with a trade or business of the taxpayer. Certain items are not included in QBI, such as short-term or long-term capital gains or losses, dividends and interest income, reasonable compensation received by a shareholder of an S corporation, and guaranteed payments received by a partner for services rendered in connection with the trade or business of the partnership. Performing services as an employee is not a trade or business under Section 199A. Therefore, wages never qualify as QBI.

Exclusion of Specified Service, Trade or Business

An SSTB is any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, athletics, financial services, brokerage services, investing and investment management trading, dealing in securities, and any trade or business in which the principal asset is the reputation or skill of one or more of its employees or owners. A trade or business providing more than 80% of its services or property to an SSTB, where the trade or business is owned 50% or more by the owners of the SSTB, will also be considered an SSTB. On the other hand, architectural and engineering professional service firms fall outside the definition of an SSTB.

Section 199A excludes an SSTB from the definition of a qualified trade or business if the taxable income of the taxpayers who own the SSTB exceed a certain threshold. For 2019, the deduction begins to be phased out for taxpayers filing singly when their taxable income reaches $160,700 and then the deduction is fully lost by the time their taxable income reaches $210,700. For married taxpayers filing jointly the deduction begins to be phased out when their taxable income reaches $321,400 and then the deduction is fully lost when their taxable income reaches $421,400.

Reducing Taxable Income Below the Threshold Amount

It would be easy to qualify an SSTB for the QBI deduction if taxpayers could simply split the SSTB into component operations. However, the regulations impose certain controlled group rules on this strategy that cause it to fail in many circumstances. Other strategies may be unavailable because the owners must be licensed members of the profession constituting the SSTB. In those cases, a cash balance plan may be the perfect solution for reducing the taxable income of the owner of the SSTB, so that the owner may qualify for the QBI deduction.

What is a Cash Balance Plan?

A cash balance plan is a type of defined benefit pension plan. In the classic defined benefit pension plan, the employer promises to pay the participant a retirement benefit that is predetermined by a formula based typically on the employee’s final average compensation and years of service at retirement. Unlike a 401(k) or profit sharing plan, a participant in a defined benefit pension plan does not have an actual account balance and is typically entitled to a benefit payable in the form of an annuity upon retirement.

A cash balance plan is often referred to as a hybrid pension plan because its benefit formula and payment method makes it look very much like a 401(k) or profit sharing plan. However, with a cash balance plan the participant only has a hypothetical account balance which is really a notional bookkeeping account used to determine the participant’s benefit entitlement.

The contributions credited to the participant’s hypothetical account are usually based upon a percentage of the participant’s compensation, although it can be a flat dollar amount or a variable amount based upon age and/or years of service. Unlike a 401(k) or profit sharing plan, where the investments determine the rate of growth, the amount contributed to the participant’s hypothetical account in a cash balance plan is credited with interest each year based upon any one of a number of permissible “market rates” of return established by the IRS.

Why a Cash Balance Plan Works so Well

Depending on the age and, to some extent, compensation of the SSTB owner as compared to the employees, the SSTB owner can retain control over a substantial portion of the entity’s profits transferred to the cash balance plan. This is based upon being able to demonstrate that the contributions to the SSTB owner’s hypothetical account under the cash balance plan provide the SSTB owner with a projected retirement benefit that is no greater, as a percentage of the SSTB’s self-employment income, than the benefits provided to the much younger employees. Moreover, the SSTB owner is able to take a 100% (not 20%) tax deduction within the limits permitted on the amount contributed to the cash balance plan.

Contributions to the cash balance plan can also vary from year to year as long as the required benefit accrual rates are satisfied. This is because unlike many defined benefit pension plans the cash balance plan usually bases contributions on the participant’s compensation for the plan year in question and not on the participant’s final average compensation. Thus, as the SSTB owner’s self-employment income increases or decreases, the SSTB owner will be able to adjust the contribution level to the plan.

Generally, deductible contributions to a cash balance plan also increase with the age of the SSTB owner, so that as the SSTB owner’s earnings increase the reduction of taxable income down to the threshold amount may nevertheless be attained.

Questions

A cash balance plan has traditionally been an excellent vehicle for providing business owners with significant income tax deductions, tax-free accumulation of assets, retirement security and asset protection. With the passage of the TCJA, another attractive feature of the cash balance plan is the ability to use it to qualify the SSTB owner for the QBI deduction. If you have a client who owns an SSTB and is unable to qualify for the QBI deduction because taxable income exceeds the threshold amounts, then please feel free to contact our Benefits Group if you would like more information on this strategy.