

# New Regulations for Section 199A Impact Retirement Planning



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For individuals who are business owners or self-employed, new section 199A of the tax code is a key provision of the Tax Cuts and Jobs Act (TCJA) of 2017. In January 2019, the IRS issued final regulations for section 199A.

These regulations help to clarify how retirement planning has been impacted by section 199A. Astute use of IRAs and employer plans may lead to more efficient claiming of the qualified business income (QBI) deduction and better tax results for affected clients.

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## QBI Basics

Just as the TCJA lowered tax rates for regular C corporations, it

also created section 199A, which provides a QBI deduction for certain taxpayers doing business in other ways. Those possibly eligible for the deduction include sole proprietors and people who report pass-through income from S corporations, partnerships, and LLCs. If no limitations apply, the QBI deduction is 20%.

**Example:** If Walt has QBI of \$100,000, he can take a \$20,000 deduction on his tax return.

As might be expected, the QBI deduction may not be that simple. For one thing, the deduction is capped at the lesser of 20% of QBI or 20% of taxable income.

Suppose Walt's taxable income, after all deductions, is \$80,000. His QBI deduction would be reduced to \$16,000 (20% of \$80,000). Only if Walt's taxable income is at least \$100,000 will he be able to take the full \$20,000 QBI deduction.

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## Income Thresholds

Section 199A also includes taxable income thresholds, such as

\$160,700 for single taxpayers and \$321,400 for joint filers in 2019. (These thresholds, which are indexed for inflation, were \$157,500 and \$315,000 for 2018.)

If someone's taxable income is under the relevant threshold, retirement planning is fairly straightforward. Contributions can be made on a pre-tax or after-tax basis (or a combination thereof), as further explained.

However, planning becomes more complex for clients with taxable income over the thresholds. For these clients, a formula involving wages and basis in the business is applied, limiting their QBI.

In addition, clients with income from certain service trades or businesses, including doctors and lawyers and consultants, among many others, face a phaseout of QBI. In 2019, the phaseout range goes up to taxable income of \$210,700 (\$421,400 on joint returns), so clients with higher income from these lines of business may not get any QBI deduction.

*If those are the basics of section 199A, what retirement strategies might be valuable?* The final regulations confirm that certain principles apply, as illustrated in the following examples.

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### **The 80-Percenter**

Suppose that Sara, age 28, is a junior partner in a dental practice. Sara and her husband, Paul, will report around \$250,000 of taxable income in 2019.

In terms of retirement planning for QBI, the couple's situation might be termed low-hanging fruit, as they are well below the \$321,400-\$421,400 phaseout range for joint filers. Sara will be entitled to a QBI deduction without having to deal with the aforementioned formula or the fact that her dental occupation is a listed service trade or business.

The catch, for Sara, is that the new final regulations confirm that a pre-tax deduction for retirement plan contributions is included in the calculation of QBI. In effect, every dollar that Sara defers with a contribution to, say, a traditional 401(k) plan also reduces her QBI deduction by 20 cents.

Therefore, Sara is getting only 80% of the benefit from a tax-deferred retirement plan. If Sara and Paul are in the 24% federal income tax bracket, Sara effectively would defer tax at 19.2% (80% of 24%), with a traditional 401(k) contribution.

However, when Sara withdraws the money from her 401(k), or from an IRA after a rollover, there will be no 20% tax benefit. She'll owe tax at her full ordinary tax rate, no matter how high tax rates might be in the future.

If Sara's dental practice has a Roth 401(k) option, Sara might choose that version for her retirement contribution. Sara and Paul would pay the tax at today's low rate of 24% and possibly reap decades of

tax-free investment buildup in the Roth account.

Yet another possibility would be for Sara to contribute only enough to her 401(k) to get the employer match, if one is offered. The balance of her retirement saving might go into a deferred annuity or a permanent life insurance policy.

Insurance products probably won't offer the asset protection that a qualified plan can deliver. As an advisor, you can add value by going through all of these possibilities with clients in Sara's situation and helping them make an informed decision.

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### **Down with Income**

Continuing the previous example, suppose that the lead partner in Sara's dental practice is Olivia, age 45. Olivia and her husband, Nate (who is a CEO without QBI), have taxable income of \$350,000 on their joint return, putting them over the \$321,400 threshold this year. Because Olivia's QBI comes from a listed trade or business, the couple is in the described phaseout range.

If Olivia can contribute \$30,000 to a pre-tax pension plan this year, that would bring their taxable income under the threshold amount and permit a relatively uncomplicated QBI deduction for her and Nate. It's true that Olivia also would be an 80-percenter, as is the case with Sara, because this pre-tax pension plan contribution will reduce her QBI.

Olivia might be getting only an 80% deduction for her pension plan contribution, but she would be increasing her QBI deduction, which would be a 100%, dollar-

for-dollar reduction on Olivia and Nate's tax return. In some cases, the payoff for this type of income reduction strategy can be as high as a 163% tax deduction, a significant current tax savings.

In the real world, many companies that generate QBI have a retirement plan in place. Let's suppose that for 2019, Olivia already contributes the maximum amount to her company's defined contribution plan, which has resulted in the couples' projected \$350,000 of joint taxable income.

In such a scenario, a possible solution is to pair a new defined benefit plan with the existing defined contribution plan, for a further reduction in taxable income. If the existing company plan is something other than a defined contribution plan, such as a SEP-IRA, it may be necessary to consult a pension expert in order to avoid complications.

Indeed, maneuvering above the income thresholds likely will require some sophisticated number crunching, requiring input from tax and pension professionals. It's not possible for anyone to know everything about everything, and that's especially true when it comes to section 199A.

Financial advisors other than tax or pension professionals can act as "hunter gatherers," finding clients who could benefit from QBI planning and arranging meetings with appropriate experts.

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### **RMDs in Sight**

Suppose that another partner in this dental practice is Luke, age 66, who plans to retire in a few years. Once Luke retires, he will soon reach age 70½ and begin required minimum distributions (RMDs) from his retirement account.

Luke has been reducing his working hours. Thus, his income is below the taxable income

threshold for calculating the QBI deduction. Therefore, Luke might not want to load up on pre-tax retirement plan contributions, if the interaction with the QBI deduction makes him an 80-percenter.

Deferring tax at, say, 17.6% (80% of the posted 22% tax rate) or 19.2% (80% of 24%) might not be appealing if Luke will shortly be withdrawing dollars at his full ordinary tax rate. Luke won't have the decades of possible tax-deferred buildup that younger Sara could expect to enjoy.

Thus, taxpayers who are below the QBI income threshold while nearing their RMDs might want to minimize pre-tax retirement plan contributions, which can produce this negative tax arbitrage. Roth accounts, permanent life insurance (if healthy), or annuities could be considered as alternatives.

For more in-depth reading on Section 199A, visit [ultimateestateplanner.com](http://ultimateestateplanner.com) and purchase the 505-page downloadable, PDF eBook: *Qualified Business Income Deduction* by Robert S. Keebler, CPA/PFS, MST, AEP (Distinguished) & Peter J. Melcher, JD, MBA, LL.M.

### Choosing Sides

In some of the examples, a taxpayer with QBI is married to a spouse whose earnings are not considered QBI. If such couples are above the QBI income threshold, reducing taxable income via pre-tax retirement plan contributions might expand the QBI deduction.

Generally, it would be better for the spouse without QBI to make the pre-tax contribution. A payroll employee may be able to get a 100% tax deduction, while the

spouse with QBI could get an 80% deduction.

Similar logic might apply to clients with multiple sources of income, including some generating QBI. Arranging for pre-tax contributions from regular employment/payroll income, rather than from an entity producing QBI, might be better.

### Up with Income

It may seem counterintuitive, but in some cases, increasing taxable income can be a tax-savvy move, considering QBI implications. That could be the case for clients whose QBI is limited because of low taxable income.

Earlier, it was explained that self-employed Walt had \$100,000 of QBI but his deduction was limited to \$16,000 (16% instead of 20% of QBI), because his taxable income was only \$80,000 — *lower than his QBI*. In such situations, another bit of retirement planning, like a Roth IRA conversion could be savvy.

Suppose Walt converts \$21,000 of his traditional IRA to the Roth side, bringing his taxable income to \$101,000. Now, Walt can take a \$20,000 QBI deduction (20% of \$100,000), because his QBI will be less than his taxable income.

Assume Walt, a single filer, would pick up \$21,000 in income from the Roth conversion but increase his QBI deduction by \$4,000, so his taxable income would increase by \$17,000. He'd move from the 22% tax bracket into the 24% bracket, so he'd owe around \$4,000 in tax from the \$21,000 conversion. That's an effective tax rate under 20% to move money into a potentially tax-free Roth IRA.

### Fine Points

If clients need to reduce taxable income to boost their QBI deduction, another possible tactic is to sign up for a high deductible health plan that permits

contributions to a health savings account (HSA).

In 2019, tax-deductible HSA contributions can be as much as \$8,000 for family coverage over age 55. HSA investments can grow, untaxed, and qualified distributions also can be tax-free, perhaps in retirement.

Another new development that may interest financial advisors: in new proposed regulations, the IRS expanded the 20% QBI deduction for investments in real estate investment trusts (REITs) to REIT mutual funds and REIT ETFs. There are no income limits for this QBI deduction.

Therefore, if advisors urge clients to invest in REITs or REIT funds, those holdings should go into a taxable account, to use the QBI deduction. If these assets are in tax-deferred retirement accounts, including traditional IRAs, subsequent distributions will be taxed at ordinary income rates, and the QBI tax break will be lost. ■

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