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Pass-through Income Tax Rates Could Undermine Incentives for Small Business Retirement Plans and Impact Millions of Non-Owner Employees

Summary

New proposed tax rates would mean that certain small business owners would pay more in taxes on contributions to a retirement plan than if they took that business income as current income. This not only removes the financial incentives for establishing a retirement plan, but actually creates a financial disincentive for doing so.

Background

More than 90% of businesses are organized as pass-through entities (partnerships, S corps, and small business limited liability corporations). More than 320,000 of these entities sponsor a retirement plan for their workforce with an average size of about 75 employees. If the tax treatment of small business pass-through entities does not properly account for retirement plan contributions allocable to the owners, the retirement security of up to 24 million non-owner workers could be threatened.

The Senate version of the Tax Cuts and Jobs Act includes a deduction equal to 23% of the qualified business income allocated to owners of pass-through entities. Effectively, this means a small business owner who is in the 35% tax rate will enjoy a marginal tax rate of 27% on her business income. Any retirement plan contributions allocable to the owner of a pass-through business will be applied as a deduction in the calculation of qualified business income at the business owner's effective tax rate for the pass-through income, which is at the 27% marginal tax rate as the following example for a Subchapter S shareholder-employee shows:

Pass-Through Income	$500,000
Cash Balance Plan Contribution	$60,000
Qualified Business Income	$440,000
Pass-Through Deduction (23%)	$101,200
Taxable Pass-Through Income	$338,800
Tax on Pass-Through Income (35%)	$118,580
Effective Tax Rate ($118,580 ÷ $440,000)	26.95%

By contrast, retirement plan contributions (and accrued earnings), when ultimately distributed to the owner from the plan at retirement, will be subject to ordinary income tax rates. For many successful small business owners, that rate is likely to be the same 35% marginal ordinary income tax rate that applied to them during their working career (when the contributions were made). This means small business owners with qualified business income will pay much higher taxes on their deferred income contributed to a retirement plan (35%) as compared to simply paying tax currently at the lower qualified business income tax rate (27%) under the Senate Finance Committee bill. This eliminates any incentive for small business owners to set aside money for their own retirement or to establish a retirement plan for their employees.

Impact on Small Business Retirement Plans

The disincentive for a small business owner to save in a retirement plan can be illustrated through a basic example. Sarah is the owner of a printing company that is organized as a Subchapter S corporation. She has spent a long time building her business and she is now in a position to begin saving for retirement at age 50. She plans on saving $60,000 per year until she reaches age 65—her planned retirement age. She also plans on investing conservatively by purchasing and holding

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investments expected to produce an annual rate of return of 4%. To accomplish this she is considering a cash balance defined benefit plan since it offers a plan design consistent with her investment objectives.

Saving in a Qualified Retirement Plan

Under the Senate version of the Tax Cuts and Jobs Act a small business owner who is in the 35% ordinary income tax bracket will enjoy a marginal tax rate of 27% on her qualified business income. If $60,000 is contributed to the cash balance plan on Sarah's behalf it will provide the following tax and retirement benefits:

Cash Balance Plan Contribution	$60,000
Annual Tax Deferred (27%)	$16,200
Accumulations @4% Over 15 Years	$1,309,472
Tax on Accumulations at Ordinary Tax Rates (35%)	$458,315
Post-Tax Retirement Savings	$851,157

Saving Outside a Qualified Retirement Plan

An advisor suggests to Sarah that she would be better off not creating a cash balance plan and would in fact be better off currently paying the tax on the $60,000 she wants to save because of the preferred tax rate on qualified business income. This approach produces over $44,000 more in retirement savings for Sarah:

After-Tax Savings on $60,000 (27%)	$43,800
Accumulations @4% Over 15 Years	$955,914
Tax on Capital Gains Deferred until Retirement with Buy and Hold Strategy (23.8%)	$60,717
Post-Tax Savings for Retirement	$895,197
Benefit of Saving Outside the Plan	$44,040

Problem and Solution

Without any incentive for the small business owner to save in a retirement plan, many will choose not to offer any plan at all given the administrative costs and ERISA liability that accompanies sponsoring a plan. Without a workplace retirement plan, Employee Benefits Research Institute data clearly shows that small business employees are fifteen times less likely to save for retirement.

Unless the mismatch of tax rates on current pass-through income and deferred retirement savings is addressed, small business owners of pass-through entities will be financially penalized for saving in a retirement plan. The solution involves matching the tax rate on the deduction for allocable retirement plan contributions of the small business owner (which includes deferrals, matches, and profit-sharing plan contributions or defined benefit accruals) with the tax rate the small business owner will pay when the money is withdrawn from the plan at retirement. In other words, a deduction of allocable retirement plan contributions at ordinary income tax rates to match the taxation of retirement plan distributions at ordinary income tax rates.