How the 199A Deduction Impacts 401k Decisions and Tax Rates

[Editor's Note: The following guest post was submitted by Timothy Schmidt, DMD. Throughout Tim's career, he's worked various employment situations — as a W2 employee, a 1099 contractor, and is currently an owner/partner in a dental practice. We have no financial relationship. The 199A deduction has affected many of our financial lives in a big way this year and in this post, Dr. Schmidt describes the changes in his life.]

I've been thinking a lot about the 199a (qualified business income) deduction, and how it impacts some of my own tax and 401k decisions this year.

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The 199A Deduction

The [199a deduction](#) is an exciting change in the tax law and potentially very relevant to health care providers. There is an ongoing trend for health care providers to move away from traditional W2 employment in favor of business income. For many, this business income is a supplement to their W2 income and may come from moonlighting (1099 contract worker). Others have eliminated their W2 altogether and are either contracted for all services or are practice owners themselves. I myself am a dentist and practice owner, and my LLC is taxed as an S-corporation.

Now, in case you don't already know, the 199a deduction applies to anyone that receives business income AND has a final taxable income of no more than $207,500 (single) or $415,000 (married filing jointly)… although the deduction begins to phase out at $157,000 (single) and $315,000 (married). It can also apply to others above this income level but only if their business income comes for a non-service business (providing patient care IS a service business).

Now, how does this deduction affect 401k plans and tax rates? Well, also important to remember, is that the amount of the 199a deduction is 20% of whichever is LESSER of the two: total business income or final taxable income. With that in mind, let's consider a few scenarios.

How Does the 199a Deduction Affect 401k Plans and Tax Rates?

Scenario #1:

Taxable income is BELOW threshold ($315k married)… and taxable income is LESS THAN total business income.

This group includes contract workers (1099 "employee") and business owners that are taxed as sole proprietor… and some that are taxed as S-corporation.

EXAMPLE:

An associate dentist is hired as a contract worker (LLC taxed as sole proprietor) and has no W2 income. Her entire income $275,000 is business income and her final taxable income is $225,000. The tax savings is calculated by 225,000 (taxable income) x 20% x tax rate (24%)= **$10,800 in tax savings.**

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Those are some nice tax savings… but here's another nugget. In this scenario, not only does the 199a reduce your tax bill, but it also essentially lowers your MARGINAL tax rate by 20%. Meaning, if you were to increase taxable income (like by making ROTH contributions instead of traditional 401k contributions) that increase would be taxed at a 20% discount. So for our dentist in the example above, instead of being taxed at 24%, added income will essentially be taxed at an appealing 19.2%.

So what does this mean for tax/401k planning?

Well, if I were in this position, I would make ROTH 401-k contributions instead of tax-deferred (assuming the option is available). A 19.2% marginal tax rate seems hard to beat, even in retirement. Also, remember that you may receive a 199a tax deduction now but won’t have that deduction in retirement… unless of course, you continue to have business income in retirement. So if somehow tax brackets did not change, and you found yourself in the same marginal tax rate in retirement as you are in now, you would still have a 20% discount in favor of choosing ROTH.

Scenario #2:

Taxable income is BELOW threshold ($315k married)… and taxable income is GREATER THAN total business income

This group includes those who moonlight or have a business on the side in addition to their W2 income. It will also include many pass-through entities taxed as S-corporation.

EXAMPLE:

A Radiologist is employed by the hospital where he makes $250k (W2 income) and is also contracted by another hospital where he makes another $90k (1099). His gross income is $340k but his taxable income is $280k. Tax savings come to $90,000 (business income) x 20% x 24% (tax rate)= **$4,320 tax savings**

Compared to scenario #1, one significant change is that while the 199a deduction may still effectively reduce your tax rate by 20% (from 24% to 19.2%) on a portion of your income, it will NOT effectively change your MARGINAL tax rate. Which means, if you elect to make ROTH 401k contributions, you will be taxed at 24% on those contributions.

Timothy Schmidt, DMD

This is the scenario that I personally will fall into this year… I have decided to make ROTH 401k contributions this year.

Scenario #3

Taxable income is in the phaseout threshold (between $315k-4 15k married)

EXAMPLE: Dentist owns his private practice and earns $440,000 and has elected to be taxed as an S-corporation. He has decided to be paid $200,000 as W2 income and $240,000 as business income and has a taxable income of $360,000. His tax savings are calculated by $240,000 (business income) x 20% x 45% (phaseout) x 32% (tax rate)= **$6,912 tax savings**

I find it interesting that the tax law makes a significant change once your taxable income reaches $315,000. All of a sudden, not only do you begin to phase out of the 199a deduction, but you also enter a significantly higher tax bracket (from 24% to 32%). You will want to run your own numbers, but obviously, the 199a deduction has a less glamorous effect whether the taxable income is higher (effectively changing tax rate for a portion of income) or business income is higher (effectively changing the tax rate for a portion of income and marginal tax rate).

Scenario #4

Taxable income is greater than the 199a threshold limit ($415,000)

Sorry, the only way to take advantage of the 199a deduction is either to reduce taxable income or somehow reclassify portions of income to come from non-service business. There is surely more to say on this topic, but not for this article.

Virtually all tax decisions depend on your marginal tax rate. For example, I remember when we first set up a 401k plan in our dental office. My partner and I chose a safe-harbor 401k plan to maximize our contributions. However, at the end of the year when we analyzed our “profit sharing” contribution options, we learned that in order to contribute heavily to our own plans, we would also have to contribute to our employee’s plans. In fact, as I neared my max contribution, the required “cost” (amount needed in employee contributions) reached 28%… which also happened to be my tax bracket that year. Needless to say, I would not continue to increase profit-sharing contributions to my own 401k when the cost is greater than my marginal tax rate (time to contribute to taxable?).

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When considering the impact of the 199a (qualified business income) deduction, it can be helpful to consider it an effective reduction in tax rate. And while it’s not quite that simple (the deduction can drop you into a new bracket) this perspective can be helpful for tax planning purposes, including 401k decisions.

Remember, when your taxable income is less than your qualified business income, the 199a (qualified business income) deduction effectively lowers marginal tax rate by 20%… so any additional income you add on will likewise benefit with that lower tax rate. Conversely, when qualified business income is less than taxable income, the tax rate is still effectively lowered, but marginal tax rate is not… and added income will not receive the 20% deduction.

How has the 199a deduction affected your retirement/tax planning? Share your approach and comment below!