Tax Cut and Jobs Act for Service Businesses

What Professional Practitioners Need to Know for 2018 & Beyond

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Meet The Speaker

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Chuck Thornton, CPA specializes in tax planning, compliance and tax representation before governmental authorities. Chuck has lectured locally and nationally on topics such as tax law, asset projections and strategic tax planning. He works with many practitioners in areas of taxation. Both the American Institute of Certified Public Accountants and the Arizona Society of Certified Public Accountants have honored Chuck as the Speaker of the Year.

Email your questions to Chuck. If they are not answered at the end of the presentation, we will get back to you via email.

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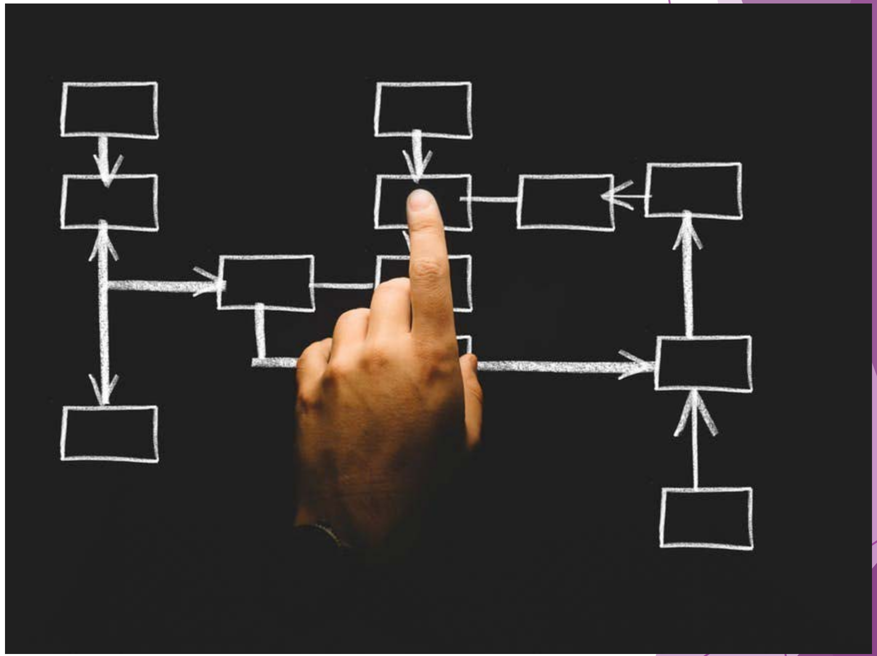
Major Points We Will Discuss

- C Corporate Tax Rates—Don't think that this is for you
- New 20% Pass Through Deduction (Section 199A)
- Limitations for Specified Service Business
- Wrapping up with Some Ideas



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Corporations

- Can be a State Formed Legal Corporation
- S Election or Remain a C Corporation
- Entity Elections
  - Can be S
  - Can be C

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C or S Historical Positives and Negatives

- C Corporation
  - Income at lower levels taxed at lower than individual rates—15% However, advantage quickly evaporates
  - Double Tax
- S Corporation
  - Income pass through, sometimes initially at higher rate since individual could be higher than lower 15% discussed above
  - No Double Tax
  - Possible FICA Savings
  - No Built in Gains Tax (well maybe not)

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But Now New Lower Tax Rate for C Corporations

Taxable Income	Prior Rate
Up to $50,000	15%
$50,001-$75,000	25%
$75,001-$10,000,000	34%
$10,000,000*	35%

But Starting in 2018

Simply 21%

Why not make all entities C- Corporations?

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New C Corporate rates are basically fictitious, unless you never want to take out income—so don't be fooled by this!

- And when you do, here is an example of what happens
- Let's use an example of a MFJ with taxable income of $310,000

Corporate Income	$1,000
Tax @ 21%	(210)
Net after tax	790
Taxed as shareholder	
Rate (new) 24%	(190)
Net	$600

- This is an effective 40% Tax Rate!
- Had this been a Sub S the Tax Rate would be 24%!

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Another Reason NOT to be a C Corporation

- In order to avoid double tax, Practitioners need to take out a higher salary, than what might be an ordinary salary so profits are not left in practice (if C corporation)
- Assume profit before Doctor's Salary is $1,000,000. That would mean, to avoid the double tax the salary would have to be $1,000,000.
- After the FICA base is over, Medicare tax still continues at the rate of 3.8% (Employer and employee). After $250,000 of wages there is another effective additional tax of .9%. So as generally, on wage income there is a tax of 4.7 (3.8 + .9) So rounding say 5.0%
- If Doctor's wages are reduced by $600,000 for a wage of $400,000 there would be a $30,000 savings ($600,000 x 0.05)
- Cannot do this in a C Corporation

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Getting out of a C Corporation into an S

- Converting to an S can cause built in Gains Tax—Fairly High
- There are ways to do this and avoid built in Gains Tax.
- If you are not a Sub S practice you should visit with your tax advisor. The new law may well make another reason—saving the 5%, but maybe getting the 20% deduction!

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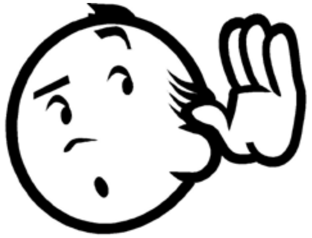
Deduction for Qualified Business Income of Pass-thru entities—so we have not left the discussion of the C Corporations

- This is the big one, and the one we will spend some time on
- Basically, (with various exceptions and limitations)
  - You get a deduction of 20% of your Qualified Business Income
    That is somewhat your K-1 profit.
  - So as a starter if your qualified business income is $100,000, you get a deduction against that for 20% and hence a $20,000 deduction
  - And if your tax bracket is 33% your tax savings is $6,600
  - Sound interesting?



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So while you're thinking of what to do with the savings, lets start with definitions.

- Qualified Business Income (QBI)(Section 199A) a new term in the code!
- QBI means income from any trade or business other than
  - **A specified service trade or business**, or
  - A trade or business if performing services as employee (ie W-2, so if you work for someone, Section 199A has no application to your wages.)
- What components are not part of QBI?
  - Must be associated with conduct of trade or business
  - Can apply to real estate entities – watch out for Triple Net Leases
  - Does not include effectively investment income
  - Does not include Reasonable Compensation paid to tax payer (You cannot include your wages as QBI)
  - Does not include Guaranteed Payments from a Partnership.
- Big Opportunity for Partnerships

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So while you’re thinking of what to do with the savings, lets start with definitions (continued)

- What is a specified service trade or business
  - Specifically excludes engineers and architects
  - Performance of services in the field of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial service broker services or any other trade or business is the reputation of skill of 1 or more employees
  - But, This will not apply under certain income ranges
  - Regs 1.448-1T provides an interesting interpretation.
- *Meaning of services performed in the field of health.—*

“For purposes of paragraph (e)(4)(i)(A) of this section, <u>the performance of services in the field of health means the provision of medical services by physicians, nurses, dentists, and other similar health-care professionals”</u>

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Certain Principles Apply

- QBI starts with taxable income
- Excludes investment type income
- Deduction of 20% of domestic qualified income – hence not foreign sources
- Once your total taxable income exceeds $415,000 the deduction is further limited to the greater of
  - 50% of W-2 wages, or
  - 25% of W-2 wages plus 2.5% of unadjusted basis of property

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Phase Out Rules

- If your taxable income is less than $315,000, then there is no distinction on allowance of the deduction as to whether or not you are a qualified service or not.
- Once your taxable income is greater than $315,000 but less than $415,000 the deduction if phased out
- SO, if you are a service provider (other than engineer or architect) and your taxable income is over $415,000 then you will get no deduction - unless of course you get creative in your tax planning (See Ideas)
- Remember for Non-Services Providers there is the W-2/Capital Limit… but not for Medical Service Providers

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Formula and Example of Phase Out Rule

- Assume MJF

$$1 - \left(\frac{\text{Taxable income } - \$315{,}000}{\$100{,}000} \right) \text{ x QBI X } 20\%$$

- This is the same phase out for non-professional practices and real estate
- Example: Assume taxable income $365,000 and QBI of $300,000.

  Normal deduction would have been 20% of $300,000 or $60,000.

  But phase out is $365,000 - $315,000 = $50,000

  Then $50,000/$100,000 = 50%

  Deduction is now 50% of $60,000 or $30,000

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Example for Non-Professional Service Provider

Jack files MFS. He has a Schedule C Sole Proprietorship and has taxable income from that business of $150,000 (QBI Income). His other income is $50,000 which is not QBI income.

- His taxable income, taking the standard deduction is $176,000.
- Compute 20% times QBI income of $150,000 = $30,000 (tentative)
- Limit 20% of taxable income x $176,000 = $35,200
- Result $30,000 Deduction
- BUT - Suppose his Taxable Income was $125,000. His deduction would be limited to 20% x $125,000 = $25,000!
- The result would be the same for a service provider since taxable income less than $315,000

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Example Taxable Income over $415,000 for non service provider

- In the prior example, QBI income is $1,000,000 (ie from Proprietorship)
- No other QBI and taxable income is $700,000
- Has W-2 wages of $250,000—employees and even his own
- Assets with unadjusted cost of $100,000
- Tentative deduction $1,000,000 x 20% = $200,000
- Limit is now NOT based on taxable income, but is based on
  - Greater of 50% wages $250,000 x 50% = <u>$125,000</u>, or
  - 25% of W-2 wages Plus 2.5 % of unadjusted basis of assets

    $250,000 x 0.25 = $62,500 plus 2.5% x 100,000 = $2,500 for total of <u>$65,000</u>

Result: QBI deduction is $125,000

But for service provider there would be no deduction since Taxable Income > $415,000

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Strategies

- Can you reduce your practice income to get your taxable income below $315,000 to $415,000?
- Perhaps use a more “hearty” retirement plan. Consider defined benefit plans. Example: Your taxable income is $470,000. Could you increase a pension plan for say another $100,000. That would bring your taxable income down to $370,000—at least some deduction of phase out
- Oil and Gas Investments
- Bonus Depreciation and Section 179 Expenses

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Strategies Continued

- Spin out buildings, if included in practice
- Spin out practice equipment and rent back
- Spin out non-service business aspects
  - Equipment
  - Non-professional employees
  - Effectively creating a support organization

Some of this thinking comes from the citation of Regs 1-448. That contemplated issues on qualified service corporations and use of fiscal year-end and highest rates. However, the committee reports refer to this code section.

This could be good asset protection strategies

Consider Cost Benefit!

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Some Other Ideas—
Make Sure They Make Economic Sense

- Ideas to Reduce Taxable Income
  - Tax-Free Bonds
  - Annuities
  - REITs generating tax sheltered income
  - Oil and Gas
  - Charitable Gifts—perhaps front loading with donor advised funds
  - Increase Debt in practice by acquisition of equipment
  - Recapitalize Practice and shift debt to service business

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Cost Recovery under Bonus Depreciation

- Prior to 1/1/2017 to 9/27/17 50%
- Acquired 9/27/2017 to 2022 100%
- Acquired 2023 80%
- Acquired 2024 60%
- Acquired 2025 40%
- Acquired 2026 20%

- Now for used or new property (which under MACRS Rules has a life less than 20 years)

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179 Depreciation

- Amount of Eligible Property Increase from $500,000 to $1,000,000
- Phase out if more than $2,500,000 of 179 property acquired
- Applies to new or used property

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179 Definition Expansion

- Qualified tangible personal property and qualified real property
  - Improvements to non-residential real property placed in service which is
    - Roofs
    - Heating, Ventilation and Air Conditioning
    - Fire Protection and Alarm Systems
    - Security Systems

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Moral on New Law

- Don't Wait Until October to do Planning
- You should have your thinking process done no later than May and should be starting now.
- If you decided to shift things, this can take time.
- Make sure whatever your strategies are that they make economic sense.

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